

***United States Court of Appeals
for the
District of Columbia Circuit***



**TRANSCRIPT OF
RECORD**

3-13-59
P-F-D
1045 am
2d case

BRIEF FOR PETITIONERS

United States Court of Appeals

FOR THE DISTRICT OF COLUMBIA CIRCUIT *United States Court of Appeals
For the
District of Columbia Circuit*

No. 14,381

FILED NOV 24 1958

Joseph W. Stewart
CLERK

P. J. GRUBER AND COMPANY, INC.,
AND PETER J. GRUBER,

Petitioners,

v.

52

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

ON PETITION FOR REVIEW FROM ORDER OF THE
SECURITIES AND EXCHANGE COMMISSION

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(i)

STATEMENT OF QUESTIONS PRESENTED*

(1) Did the Commission arbitrarily, and without substantial evidence, find that petitioner Gruber had willfully violated the registration provisions of the Securities Act of 1933 in connection with the sale of certain securities?

(2) [Omitted]*

(3) Did the Commission arbitrarily, and without substantial evidence, find that petitioner Gruber willfully violated the bookkeeping provisions of the Securities Exchange Act of 1934 and the Commission's rules thereunder?

(4) In connection with the question presented in Point (3), were the book entries in question in fact false and fictitious?

(5) In the exercise of its discretionary power to deny broker-dealer applications where the public interest so requires, did the Commission fail to make proper findings on which to base its conclusion that a denial was necessary to protect the Commission's functions and investors' interests, and, if so, was this an abuse of discretion?

(6) In denying the broker-dealer application on the grounds of public interest considerations, did the Commission rely on a consent injunction against petitioner Gruber and a company which he controlled, and, if so, was such reliance improper if in fact such injunction was entered on condition that it not be used in a broker-dealer revocation proceeding by the Securities and Exchange Commission?

* Stipulated by parties and approved by Order, dated October 15, 1958. The second question stipulated is omitted because it is not argued separately.

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SECURITIES AND EXCHANGE COMMISSION,

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ON PETITION FOR REVIEW FROM ORDER OF THE
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BRIEF FOR PETITIONERS

JURISDICTIONAL STATEMENT

This is an appeal by Peter J. Gruber and P. J. Gruber, Inc., petitioners, pursuant to Section 25 of the Securities Exchange Act of 1934¹ from an order of the Securities and Exchange Commission entered on January 15, 1958 denying P. J. Gruber & Co., Inc.'s application for registration as a broker and dealer, denying its request for withdrawal of such application, and finding that Mr. Gruber and one other were each a cause of these denials.²

¹ 48 Stat. 901 (1934), as amended, 15 U.S.C. §78y.

² Petition for Review filed March 17, 1958.

STATEMENT OF THE CASE

Petitioner Gruber is an individual engaged in the securities business through a New York Corporation, P. J. Gruber & Co., Inc., of which he is the President and sole stockholder. That corporation has been in business since 1954 and is in business today. For a time it operated not only from its New York office but also from a Washington office (R. 131).

In August, 1956, Mr. Gruber, intending to conduct his Washington business separately, incorporated in Delaware a second wholly-owned corporation under the same name as the New York corporation, i.e., P. J. Gruber & Co., Inc. (R. 131). The Delaware corporation is the second petitioner in this case, whose application for registration as a broker-dealer was denied by the Commission. (To distinguish between the two, the New York corporation which is in business and has a registration in effect will be referred to as "registrant" and the Delaware corporation will be referred to as "applicant".)

While this application was pending, the Commission on November 2, 1956 noticed a hearing to determine whether the application should be denied (R. 97-9). Accordingly, the business of the Washington office continued to be performed by registrant (R. 112-3).

In January 1957, registrant discontinued its business in the District of Columbia (R. 119). Since the applicant corporation had been organized in Delaware for the purpose of separate incorporation of the District of Columbia business, and since the District of Columbia business had been discontinued, there was no longer any purpose to be served by the requested registration. Accordingly, applicant sought to withdraw its application for a broker-dealer license (R. 119).

The request was postponed to final decision, and a hearing was held before an Examiner of the Commission. At the hearing a stipulation was introduced as to what various persons would testify if called as

witnesses (R. 110 et seq.). The only witnesses who testified under oath and subject to cross-examination at the hearing were Mr. Sacks, registrant's former manager, and Mr. Zazicki, a former salesman of registrant. Both witnesses denied the charges of the Commission. On May 31, 1957, the Examiner filed a report recommending denial (R. 164, et seq.). On January 15, 1958, the Commission issued an opinion and order which denied applicant corporation's application to register as a broker-dealer, refused the request to withdraw, and found Mr. Gruber (and also Mr. Sacks) a "cause" of the action taken against applicant (R. 195-201). This appeal followed.

The Effect of the Order Below

Although the denial of registration to applicant Delaware corporation was based upon alleged practices engaged in by Mr. Gruber's registrant New York corporation, the Commission took no action to revoke the registration of the New York corporation and registrant is still doing business in New York and free to engage in business anywhere in the United States it desires to do so. However, the Order of the Commission is not as at first appears merely a meaningless denial of the right of the applicant to do a securities business which it has no intention of doing. The Order of the Commission finding Mr. Gruber guilty of willful violations of law and declaring him to be a "cause" of the denial has a continuing and drastic effect on the registrant corporation and on Mr. Gruber personally, since his principal occupation is the affairs of registrant.

Although registrant is allowed to do business, and may if it wishes operate in Washington again, the present Order presents a constant threat that it will be used as a ground for the denial of Mr. Gruber's right to do business through registrant. It also denies to registrant or any corporation with which Mr. Gruber is connected the right to be a member of the

National Association of Securities Dealers,¹ a necessary condition to engage in the distribution of new issues. It also denies registrant the privilege generally available to other brokers and dealers to engage in the sale of small issues of securities under specific regulations of the Commission.² This is of particular importance to registrant since its business has primarily been in the field of small issues.

In addition, the Dun & Bradstreet reports which are circulated among businessmen with whom Mr. Gruber must deal, of course, carry the notation that Mr. Gruber has been found guilty of "willful" violations of law and "false and fictitious entries" which is a serious reflection upon and handicap to his business.

Thus the seemingly meaningless Order of Denial in the present case has drastic effects upon the business which Mr. Gruber has so far been permitted to conduct. Indeed, this is the sole purpose and effect of the Commission's Order denying the appellant a privilege which it does not desire to exercise.

Our appeal here is based on the fact that there is not a scintilla of evidence in the record to support the Commission's finding that Mr. Gruber was guilty of willful violations of the statute or that the public interest required his exclusion from the securities business in whole or in part.

The Structure Of The Statute Here Involved

Section 15(b) of the Securities Exchange Act,³ the punitive provision under which the Commission acted in this case, was intended as a remedial measure empowering the Commission, where the public interest required, to remove individuals from the securities business who conducted their business in willful violation of the securities laws.

¹ Section 15A (b)(4), 52 Stat. 1070 (1938), 15 U. S. C. 78o-3(b)(4).

² See Rule 252 (d)(3) under the Securities Act of 1933, 17 CFR 230.252 (d)(3)

³ 48 Stat. 895 (1934), as amended, 15 U. S. C. § 78o(b).

Since the statute is directed at individuals, its provisions are applicable only against individuals who are themselves guilty of willful violation of law. It prevents such individuals from acting as "partner, officer, director" or employee of any company. They are disbarred from the business. Further, the statute prevents such individuals from escaping the consequences of their own acts through corporate devices, for it prohibits disbarred persons from operating through controlled persons.

The emphasis on personal responsibility is underscored in this case by the fact that petitioner Delaware corporation had done nothing to deserve censure -- it was newly organized and had never engaged in business. It could be properly denied the right to do business only if its controlling person, petitioner Gruber, was subject to disbarment personally.

Further, the order of the Commission is not based on any violation of law by registrant New York corporation. Registrant, whatever its activities may be, is a separate corporation which, under the statute, the Commission may not consider. The statute gives the Commission the right to deny a registration application only for specified violations of law (1) by the same corporation or (2) by a person who controls or is controlled by that corporation. Since the registrant did not control, nor was it controlled by, the applicant corporation, actions of the registrant may not be considered as a basis for denial of applicant's license.

Accordingly, in order to deny the application of the newly-organized Delaware corporation, the Commission had to find, and it did in fact find, that Mr. Gruber personally had willfully violated the securities laws and that the public interest required that he be denied the right to continue in the securities business.

If Mr. Gruber did not in fact personally, willfully violate the law, or aid or abet the commission of violations, then the Commission's action

in denying the Delaware corporation's broker-dealer application must be reversed.

As we shall see below, there is no evidence of this character whatsoever, nor did the Commission even attempt to adduce any relevant evidence to this end.

The Charges

Section 15(b) of the Securities Exchange Act¹ provides that registration may be denied if the Commission "finds that such denial or revocation is in the public interest and . . ." that any officer, director or controlling person of the broker or dealer "has willfully violated any provision of the Securities Act of 1933 or of this chapter (Securities Exchange Act of 1934) or of any rule or regulation thereunder".

The charges against Mr. Gruber are:

(1) Willful violation of the provisions of Section 5(a)(1) of the Securities Act of 1933² requiring registration of securities, and

(2) Willful violation of Section 17(a) of the Exchange Act³ and Rule 17a-3⁴ which requires brokers and dealers to make "a memorandum of each purchase and sale".

The Commission found against Mr. Gruber on both of these charges. The Commission also found, under Section 15(b) of the Securities Exchange Act, that it was necessary in the public interest to deny applicant's registration application; and further, under Section 15A (b)(4) of that Act, that Mr. Gruber was a "cause" of the denial (R. 195-201).

¹ 48 Stat. 895 (1934), as amended, 15 USC § 78o(b).

² 48 Stat. 77 (1933), as amended, 15 USC § 77e(a)(1).

³ 48 Stat. 897 (1934), as amended, 15 USC § 78q(a).

⁴ 17 CFR § 240.17a-3.

The Evidence on the First Charge

The Commission charged that Mr. Gruber willfully violated Section 5(a)(1) of the Securities Act by selling the common stock of Acoustica Associates, Inc. through registrant corporation without a registration statement being in effect. The facts are (R. 113, 119-21, 135) that Acoustica Associates, Inc., a New York corporation doing business in New York, desired to sell 49,500 shares to the public in New York at \$1 a share. Registrant sold such shares at the specified price relying on an exemption from registration under Section 3(a)(11) of the Securities Act which provides that such an offering is exempt from registration if sold exclusively to residents of the State of the offeror.¹

Mr. Gruber negotiated the agreement for the sale of the common stock in early 1956; however, he was in South America during the period when the shares were sold from March 5, through April, 1956. During the sale period, the office of registrant was in charge of a manager, one Edward Joyce. As the record reflects Mr. Joyce "was given specific instructions by Peter J. Gruber to offer and sell the stock only to New York residents".

Of the 144 transactions involved, 140 were in fact effected intra-state in New York, and 4 were effected out of the state.

No evidence was introduced to the effect that the 4 sales were made willfully or knowingly to out of state residents.

¹ Section 3(a)(11) reads as follows [48 Stat. 75 (1934), as amended, 15 USC § 77c-(a)(11)]:

"(a) Except as hereinafter expressly provided, the provisions of this subchapter shall not apply to any of the following classes of securities:

(11) Any security which is a part of an issue sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within, such State or Territory."

Reliance on this statutory exemption is common and normal, particularly in the case of small amounts of securities such as the present, where the costs of filing a registration statement would be prohibitive. In fact, this is one of the purposes of the statutory exemptions.

Immediately upon learning of such transactions, after his return to the United States, Mr. Gruber actively took steps to see what remedial measures could be taken. Offers of rescission to the purchasers were considered. However, by this time the shares were selling at a price substantially in excess of the offering price so that an offer of rescission would not have been accepted by the stockholders.

Despite the lack of any evidence to show that the 4 sales effected to out of state residents were willfully made, despite the uncontradicted evidence of the instructions given by Mr. Gruber, and despite the fact that Gruber was out of the country at the time of the offering, the Commission found that "Gruber through registrant willfully violated Section 5(a)(1)" of the Securities Act (R. 197).

The Evidence on the Second Charge

The second charge dealt with the operation of registrant's District of Columbia office while under the management of Messrs. Shumway and Sacks (R. 121-2). Here the Commission found that Mr. Gruber, whose office was in New York, willfully caused sales to be recorded on the books of registrant corporation with respect to the common stock of two corporations, Perfect-Line Manufacturing Corporation and Century Controls Corporation, where the supposed purchaser in fact did not agree to purchase the stock. The Commission said such entries were "false and fictitious" and therefore not a proper memorandum of sale required by the rule (R. 197-200). There is no testimony that Mr. Gruber knew or should have known that there was no agreement of the purchasers to buy the stocks in question. Of almost 1300 transactions the record contains evidence that only 4 of such transactions may have been of this character (R. 115-7). Those 4 transactions were conducted by telephone by salesmen in Washington, D. C.; Mr. Gruber in New York did not participate in them (ibid), nor is it claimed that he had any knowledge of their supposed fictitious character (R. 124). Yet the Commission

made a finding that Mr. Gruber willfully made false and fictitious entries.

The Testimony - Century Controls Sales

The parties stipulated that four named individuals would have testified if called as witnesses that they were asked on the telephone by a salesman of registrant corporation to allow him to send out a confirmation "to protect the stock for them" even though they had not agreed to purchase the stock. The stipulation is as follows (R. 115-6):

"19. The parties hereto further stipulate and agree that:

(a) If Margaret Howell, Vernon Barrack, Frank Wright, Samuel Lasky and others were called as witnesses they would testify that during the period from about October 1, 1956 to October 20, 1956, they were each called on the telephone on several occasions by representatives of P. J. Gruber & Co., Inc., Washington, D.C. office, who made vigorous attempts to induce each of them to purchase shares of the common stock of Century Controls Corporation's stock; that it was suggested to each of said persons that P. J. Gruber & Co., Inc. be allowed to send out a confirmation to protect the stock for them and that none of the said persons so solicited ever agreed to purchase the stock, but notwithstanding this, each of the said persons so solicited did receive, thru the United States mails, a confirmation of sales to them of shares of common stock of Century Controls Corporation which they, in fact, never agreed to purchase."

At the hearing the testimony of the two salesmen of registrant who dealt with the four named individuals was taken and they testified that in each case the investor had in fact agreed to purchase the stock.

Thus, with respect to Mrs. Howell, Mr. Sacks testified (R. 42):

Q. At the conclusion of your conversation, did she indicate that she wanted to buy this stock?

A. Yes.

Q. Was there any reservation, in your own mind, at that time, as to whether or not she had indicated the desire to buy?

A. I thought she was going to buy the stock.

With respect to the other stipulated witnesses (Barrack, Wright and Lasky), Mr. Zazicki testified under oath as follows (R. 74-7, 81-2):

Re Mr. Lasky:

Q. Did he say he would buy?

A. Yes.

Re Mr. Barrack:

Q. Did they [sic] indicate they wanted to buy Century Control Corporation stock?

A. Yes.

Q. Was there any doubt in your mind at all that they [sic] had made that purchase over the telephone?

A. No.

Re Mr. Wright:

Q. After your second telephone call, or during the course of your second telephone call with Mr. Wright, did he indicate that he wanted to buy the Century's Control stock?

A. Yes.

Q. Was there any doubt in your mind at all as to his purchase of the stock at that time?

A. No.

* * *

Q. Now, on any of these three individuals, Mr. Zazicki, was any indication made on the part of any of them, during the course of their second telephone conversation, that they were not buying the stock which you had offered to them over the telephone?

A. No.

Q. There was a definite indication on their part, in other words, that they were purchasing?

A. Yes.

* * *

Q. Then in all three instances of the people named, it is your definite statement that there was no doubt that when you finished talking to these people on the phone, that they had definitely ordered the shares of stock and that you issued the confirmation out as a result of their order?

A. Right.

The above constitutes all the direct evidence in the record with respect to the charge that Mr. Gruber falsified the books of the New York corporation by showing actual sales of stock in cases where the purchaser had allegedly not agreed to buy.

The Testimony - Perfect-Line Sales

The Commission did not introduce any testimony, stipulated or otherwise, to support its finding that false sales entries were made on transactions of Perfect-Line stock.

Other "Evidence"

The only other evidence in the record on which the Commission bases its findings with respect to the charge of false entries in connection with the Century Controls and Perfect-Line sales is the following:

1. It was stipulated and the Commission found (R. 197) that during the period from August 15 to November 2, 1956 "502 sales of common stock of Century Controls Corporation were effected and 191 of such sales were thereafter cancelled, and that 795 sales of common stock of Perfect-Line Manufacturing Corporation were effected and 352 of them were cancelled".

2. Mr. Gruber was aware of the high cancellation rate (R. 199).

3. The business was transacted over the telephone and not by personal contact (R. 123).

STATUTES INVOLVED*

The relevant provision of the Securities Act of 1933 is:

Section 5(a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly --

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; . . .

The relevant provisions of the Securities Exchange Act of 1934 are:

Section 15(b) . . .

The Commission shall, after appropriate notice and opportunity for hearing, by order deny registration to or revoke the registration of any broker or dealer if it finds that such denial or revocation is in the public interest and that (1) such broker or dealer whether prior or subsequent to becoming such, or (2) any partner, officer, director, or branch manager of such broker or dealer (or any person occupying a similar status or performing similar functions), or any person directly or indirectly controlling or controlled by such broker or dealer, whether prior or subsequent to becoming such, . . . is permanently or temporarily enjoined by order, judgment, or decree of any court of competent jurisdiction from engaging in or continuing any conduct or practice in connection with the purchase or sale of any security; or (D) has willfully violated any provisions of the Securities Act of 1933, or of this chapter, or of any rule or regulation thereunder. . . .

* Inasmuch as the Statement of Points would consist of an affirmatively stated repetition of the Questions Presented, they will not be separately stated. Instead, reference is made to the Questions Presented.

Section 17(a) . . . every broker or dealer registered pursuant to section 78o of this title, shall make, keep, and preserve for such periods, such accounts, correspondence, memoranda, papers, books, and other records, and make such reports, as the Commission by its rules and regulations may prescribe as necessary or appropriate in the public interest or for the protection of investors. . . .

SUMMARY OF ARGUMENT

I.

There is no evidence whatever to support the Commission's finding that Mr. Gruber willfully violated the registration provisions of the Securities Act by the interstate sale of a securities issue. The shares in question were sold in reliance on an exemption which would be available if sales were made exclusively to New York residents. The record shows that (1) Mr. Gruber specifically instructed his employees to offer and sell the securities issue only to New York residents, (2) Mr. Gruber had no reason to believe his instructions would not be strictly followed, (3) the shares were offered while Mr. Gruber was out of the country, (4) out of 144 transactions, 140 were effected intrastate and only 4 were effected out of state, (5) no showing was made as to whether the 4 transactions to non-residents were a willful or inadvertent violation of Mr. Gruber's instructions, and (6) upon learning of these facts on his return to the United States, Mr. Gruber made immediate inquiry to see what remedial steps could be taken; however, the shares had a good market and all investors had a profit so that offers of rescission would not have been accepted. These facts, which are undisputed, cannot support a finding of a willful violation by Mr. Gruber. The decisions of this Court, without exception, require that before such a finding can be made it must be shown that the person so charged participated in the unlawful action directly, with knowledge and

deliberation [Hughes v. Securities & Exchange Commission, 85 App. D.C. 56, 174 F.2d 969, 977 (1949); Norris & Hirshberg v. Securities & Exchange Commission, 85 App. D.C. 268, 177 F.2d 228 (1949); Broadcasting Service Organization v. Federal Communications Commission, 84 App. D.C. 152, 171 F.2d 1007 (1948)].

II.

There is no evidence whatever to support the Commission's finding that Mr. Gruber willfully violated the bookkeeping provisions of the Exchange Act, Section 17(a), and the Commission's Rules, 17a-3. The charge is that he caused sales entries to be made on registrant's books with respect to the securities of Perfect-Line Manufacturing Corporation and Century Controls Corporation although there was in fact no agreement to purchase the shares. The record shows that Mr. Gruber was not a party to, in any way responsible for, or even aware that any false entries were made. There were almost 1300 transactions in the two stocks and only 4 of them were challenged by evidence in the record. The four questioned sales were made by phone by salesmen in the District of Columbia; Gruber's office was in New York. No attempt was made to link Mr. Gruber with any of the four transactions. There is no support in the record for the charge against Mr. Gruber.

The Commission apparently sought to charge Mr. Gruber with responsibility for the alleged false entries on the assumption that a high rate of cancellations on the sales of the two issues is conclusive proof that the customers did not agree to purchase in the first place, and that Mr. Gruber must have known this. Not only is there no basis for this assumption, but the record shows the contrary. Thus, the evidence shows that the rate of sales cancellations increased even after Mr. Gruber instituted a system of independently checking purchase orders received from salesmen before issuing confirmations.

This establishes, of course, that the high rate of cancellations was not due to misrepresentation on the part of registrant's salesmen as to whether customers had agreed to purchase stock. Instead it was due to the fact that customers had changed their minds and did not wish to carry out the commitments they had made.

III.

Since the Commission did not establish personal guilt on the part of Mr. Gruber, the Commission's order is without foundation. However, its findings that registrant corporation violated the Act although irrelevant to the order appealed from is also unfounded. Thus, the Commission's finding that registrant "engaged in a practice" of false entries in the sales of the two issues was clearly erroneous inasmuch as:

(1) No testimony whatever was adduced to show that any of the 795 sales of Perfect-Line stock were improperly recorded.

(2) The Commission was able to produce, by stipulated testimony, only 4 individuals out of the 502 who received sales confirmations on the Century Control issue who claimed that they had not definitely agreed to purchase the stock prior to the receipt of such confirmations; and even as to these 4, registrant's salesmen testified under oath at the hearing that the customers had in fact given firm orders before the sales were confirmed to them. Accordingly, "the solid sense of the entire record" [Victor Products Corp. v. National Labor Relations Board, ___ App. D.C. ___, 208 F.2d 834, 839 (1953)] does not support the finding that "registrant engaged in a practice" of mailing confirmations and making book entries of sales without first securing firm purchase orders. On the contrary, the record considered as a whole dictates a precisely opposite result. Pittsburgh S.S. Co. v. National Labor Relations Board, 180 F.2d 731, 742 (6th Cir. 1950).

IV.

Assuming that the testimony of registrant's witnesses can be wholly ignored (as the Commission erroneously did) and the stipulated testimony of the four customers is accepted, there still is no rational basis for the finding that false sales entries were made in these four instances, inasmuch as the customers' testimony establishes that when the confirmations were mailed (and the sales entries were made) registrant was under a binding commitment to sell the stock unless the customers decided not to purchase. In view of the commission's public insistence on the immediate book entry of all securities transactions, the lack of a line of authority to show that the alleged practice was improper, and the requirement that provisions of the securities laws "must be strictly construed since a violation . . . may be punished as a crime" [Wright v. Securities & Exchange Commission, 112 F.2d 89, 93-4 (1940)] there is no rational basis for a finding that the questioned sales entries were "false".

V.

Assuming adequate support existed for the findings of willful violations by Mr. Gruber, reversal of the Commission's order is still required because the Commission failed to make proper findings to support its conclusion that a denial of the Delaware corporation's broker-dealer application was necessary to protect the public interest. Thus, as to the registration violation growing out of the Acoustica sales, the Commission contented itself with one cryptic statement to the effect that the "registration . . . requirements . . . must be fully observed if investors are to receive the full disclosure to which they are entitled . . ." This statement did not discharge the Commission's obligation to advise the registrant and the court why an employer's failure to comply with the statute in 4 out of 144 transactions makes it

in the public interest to deny registration where investors actually profited. Telanserphone, Inc. v. Federal Communications Commission, 97 U.S. App. D.C. 398, 231 F.2d 732, 735 (1956); Capital Transit Co. v. Public Utilities Commission, 93 U.S. App. D.C. 194, 201, 213 F.2d 176, 183, cert. denied, 348 U. S. 816. The Commission's finding on the public interest must, accordingly, be reversed as arbitrary and capricious. Broadcasting Service Organization v. Federal Communications Commission, 84 App. D.C. 152, 171 F.2d 1007 (1948).

The Commission's reasoning on the bookkeeping charge is similarly defective. Thus, the Commission made no attempt to show why (conceding, for argument, all that the Commission claims) the entry of sales on the registrant's books, where the sale was subject to cancellation by the prospective purchaser, could possibly be injurious to investors or the Commission's functions. Furthermore, the Commission's enunciation of factors bearing on the bookkeeping charges was highly improper in that it relied on a consent injunction relating to such charges entered against Mr. Gruber and the registrant in the Southern District of New York, even though it must have known, as a party to that action, that the injunction was not to be used against Mr. Gruber by the Securities & Exchange Commission prior to trial of the court action. Although the trial has not yet taken place, the Commission did rely on the injunction as one of the grounds for its punitive order against Mr. Gruber. This was clearly error.

ARGUMENT

- I. THERE IS NO EVIDENCE WHATEVER THAT MR. GRUBER WAS GUILTY OF A "WILLFUL" VIOLATION OF THE REGISTRATION PROVISIONS OF SECTION 5 OF THE SECURITIES ACT.

During March of 1956 registrant corporation sold 49,500 shares of Acoustica Associates, Inc. stock at \$1 a share. It attempted to obtain the exemption from registration provided by Section 3(a)(11) of the Securities Act which provides that such an offering is exempt from registration if sold exclusively to residents of the state of the offeror.

As fully developed in the statement of the case, the record reflects the following uncontradicted facts as to these sales:

- (1) Prior to the offering of these shares, Mr. Gruber specifically instructed his New York office manager to offer and sell the stock only to New York residents.

- (2) There was no reason for Mr. Gruber to doubt the ability or willingness of his office manager to carry out his instructions in his absence.

- (3) Mr. Gruber left on a trip to South America and was absent during the months of March and April, 1956.

- (4) In Mr. Gruber's absence abroad, the shares were so offered, and of 144 transactions which resulted, 140 were in fact effected intra-state and only 4 were effected out of state.

- (5) Upon learning of these facts on his return to the United States, Mr. Gruber took immediate steps to see what remedial measures could be taken. Offers of rescission to the purchasers were considered; however, by this time the shares were selling at a price substantially in excess of the offering price so that investors had profited rather than lost, and would not have considered an offer of rescission.

Despite these unchallenged, stipulated facts, showing Mr. Gruber's good faith and non-participation in the four improper sales, the Commission found that (R. 197) "Gruber through registrant (P. J. Gruber & Co., Inc., New York) willfully violated Section 5(a) (1) of that Act" and that this violation is a ground for denial of Mr. Gruber's right to do business.

This was clearly error, for the decisions of this Court and the other circuits, without exception, insist on a showing that the person accused had participated in the unlawful action directly, with knowledge and deliberation, or at the very least had reason to believe that an unlawful act would be committed and, therefore, had a responsibility to prevent it which he recklessly ignored.

Thus in Hughes v. Securities & Exchange Commission, 85 App. D.C. 56, 174 F.2d 969, 977 (1949), a finding of willfulness was premised on the fact that "Petitioner . . . intentionally and deliberately chose to continue her methods of operation in spite of repeated advice [from the Commission] that those methods were unlawful." (Emphasis supplied)

In Norris & Hirshberg v. Securities & Exchange Commission, 85 App. D.C. 268, 177 F.2d 228 (1949), petitioner's manipulative "shuffling" of securities in customers' accounts was held to be the result of "petitioner's conscious, knowing, and purposeful course of action" which was "so deliberately and so carefully designed for its own consistent advantage over customers that we must conclude its violations to have been willful". (Emphasis supplied)

In Broadcasting Service Organization v. Federal Communications Commission, 84 App. D.C. 152, 171 F.2d 1007 (1948), the Court reversed the Commission's finding that appellant had "willfully" and "knowingly" filed false and misleading ownership and other reports (pp. 1011-2), even though "the record . . . [was] replete with evidence that appellant's agents were careless and inaccurate and, perhaps,

lacking in good judgment as to the reports required by the Commission" (p. 1014, emphasis supplied) on the ground that no "bad faith" or "evil motive" was shown: "Moreover, and of even greater significance, the Commission's findings and the record itself . . . are equally devoid of any evidence of willfulness or, using the Supreme Court's language in the WOKO case, of 'willingness to deceive' " (p. 1013, emphasis supplied).¹

Obviously, none of the actions described in the above cases can be attributed to Mr. Gruber. Nor can it be said that he was guilty of "irresponsible behavior with respect to supervision [which] amounted to . . . recklessness", Johnson v. Securities & Exchange Commission, 198 F.2d 690, 697 (2d Cir. 1952), cert. denied, 344 U. S. 855.

Apparently, the Commission, in making its ultimate finding that Mr. Gruber was a "cause" of the denial, applied, in absolute fashion, the doctrine of respondeat superior. This was clearly error, for Johnson explicitly denies that "'cause' in Section 15A is equated with respondeat superior", 198 F.2d at 697, fn. 17.

Perhaps the salesman of the office manager willfully violated their instructions. However, the record is barren even as to this question: there is no evidence to show whether their action in the four sales was willful or inadvertent.² But even if the salesman and the office manager had in fact willfully violated the law, there is no basis for the finding made by the Commission that Mr. Gruber willfully violated the law. The record is clear to the contrary. He was not present,

¹ In Weber v. Securities & Exchange Commission, 222 F.2d 822 (2d Cir. 1955), willfulness was found where the facts showed obviously "fraudulent mis-statements and . . . wrongful diversions of funds in . . . [the] underwriting of an issue" (p. 823).

And in Pierce v. Securities & Exchange Commission, 239 F.2d 160 (9th Cir. 1956), a finding of willfulness was sustained where the Commission had made "elaborate findings of fraud" with respect to stock transactions and the contents of petitioner's financial statement (p. 162, emphasis supplied).

² In view of the fact that the sales were all made in New York City, where hundreds of thousands of people are commuters from neighboring states, it is easy to see how a mistake of this nature could occur.

did not participate in the transactions, had specifically given the necessary instructions, and had every reason to trust his office manager.

There is no showing or even suggestion that Mr. Gruber had reason to believe in advance that his instructions would not be strictly obeyed or that it would not be safe for him to leave the country and entrust the sales to his office manager. In fact, his confidence in the responsibility of his employees would seem to be supported by the fact that in 140 out of the 144 transactions, his instructions were concededly adhered to.

Further, when he found out on his return that his instructions had not been followed, he voluntarily -- and not as a result of official suggestion¹ took steps to see if remedial action by way of offers of rescission could be taken. However, as stated above, by this time, to the advantage of the investors, the stock had gone up in value,² so that rescission would be unfair to the investors. A clearer picture of good faith on Mr. Gruber's part on all points cannot be imagined. Yet, the Commission finds him guilty of "willful violation" of law and uses this supposed willful violation as a ground for denying him the right to engage in the securities business. The Commission's finding must be reversed as arbitrary and unsupported by the evidence.

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Since this record does not and cannot support the Commission's finding that Gruber willfully violated Section 5(a) (1), the Commission's decision must, therefore, as a matter of law, be reversed. For "It is, of course, true that a registration cannot be revoked unless there had been a willful violation of statute." Norris & Hirshberg v. Securities &

¹ The Commission will concede that it was only considerably later that the matter of the four sales came to the Commission's notice when Gruber voluntarily disclosed it without inquiry by the Commission.

² Today the shares are selling for \$15 a share. They had originally been sold for \$1 a share.

Exchange Commission, supra, 177 F.2d at 233. And where the Commission has been reversed on one of two charged violations, the Commission's order must be "Reversed and the cause remanded" for further consideration. Wright v. Securities & Exchange Commission, supra, 112 F.2d at 95-6.

Accordingly, even if the second charge of "false entries" were to be sustained, the Commission's order would have to be reversed. But as we shall see that charge is no better founded than the first one.

II. THERE IS NO EVIDENCE WHATEVER THAT MR. GRUBER WAS GUILTY OF A "WILLFUL" VIOLATION OF THE BOOKKEEPING PROVISIONS OF THE SECURITIES EXCHANGE ACT OR THE RULES.

A. Mr. Gruber was not directly or indirectly responsible for any false entries.

As set out in the statement of the case, the second charge dealt with the operation of registrant's District of Columbia office under the management of Mr. Sacks. Here, the Commission found that Mr. Gruber willfully caused sales entries to be made on the books of registrant corporation with respect to sales of the securities of Perfect-Line Manufacturing Corporation and Century Controls Corporation when in fact no sales had been made. This was found to be in violation of Section 17(a) of the Exchange Act and Rule 17a-3 thereunder which require brokers to make "a memorandum of each purchase and sale". The Commission claimed that the staff of registrant's Washington office had engaged in the practice of mailing confirmations of sales to members of the public and causing such sales to be entered on the books of registrant, when in fact the supposed purchasers had not agreed to purchase the securities. The Commission also found that when the ostensible purchaser refused to accept the stock, entries were made showing a cancellation of the sales previously recorded (R. 197-200).

In support of its findings, the Commission relied, basically, (1) on the stipulated testimony of four individuals (whose testimony was contradicted by registrant's salesman) who claimed that they had not agreed to purchase Century Controls securities in the telephone conversations prior to receipt of the confirmations.¹

However, assuming that "false entries" were in fact made (which, as we shall show, was not true), there is absolutely no evidence to show that Gruber was personally chargeable with any impropriety as to the entries.

Mr. Gruber had his office in New York. There were 502 transactions in Century Controls stock and 795 transactions in Perfect-Line stock in the period in question. Of these, the record contains reference to only four transactions in one of these companies (Century Controls) which are claimed to be improperly recorded. The disputed four transactions were the result of telephone conversations between employees in the Washington, D. C. office of registrant and members of the public in this area.

Mr. Gruber was, of course, not a party to the disputed telephone conversations. There is no syllable of testimony that any salesman stated to Gruber that he had improperly sent a confirmation without the customer's authorization. There is no evidence in the record that any customer complained to Gruber concerning any instance of this supposed improper "practice" either in person, on the telephone, or by writing. His District Manager, Mr. Sacks, specifically testified that under his instructions, confirmations were to be sent out only when the customer had made a definite commitment to purchase (R. 28). The record is clear and uncontradicted that Mr. Gruber had neither knowledge nor any reason to believe that confirmations were sent without proper authorization on the four disputed transactions out of well over a thousand transactions in the two securities in question.

¹ As we have shown, the Commission did not introduce any such testimony as to the Perfect-Line sales.

And indeed the Commission stipulated Mr. Gruber's testimony that Mr. Gruber "was not aware that the transactions reflected in the blotter and ledgers were false and fictitious" (R. 124). Plainly the Commission's findings that Mr. Gruber willfully violated the record keeping provisions of the Exchange Act are absolutely unfounded.

Since the Commission is normally not in the habit of making such unfounded findings we feel it appropriate to consider how it may have been misled in this case.

The only answer suggested by the opinion is that the Commission considered the high rate of cancellations on the Perfect-Line and Century Controls transactions as conclusive proof that firm commitments had not been received before confirmations were mailed to the customers. The Commission does not make this statement flatly. Nor did it offer proof to this effect. But it obviously assumed this to be the case.¹ This was clearly error. The Commission, of course, was not entitled to make any such assumption,--it could proceed only on proof. And further the record contains conclusive proof that the assumption was erroneous.

Thus, the Commission found that 352 of the 795 sales of Perfect-Line stock and 191 of the 502 sales of Century Controls stock were cancelled. This rate is of course high. But the record shows conclusively that the high rate of cancellations was due to causes other than the sending of confirmations to customers who had not ordered the shares.

The record shows without contradiction that when registrant was first informed in November of 1956 that the Commission was concerned with the high rate of sales cancellations, Albert Friedman,² a trusted

¹ Else it would not talk of a "practice" based on four transactions. Nor could it find a willful violation by Mr. Gruber. But if a cancellation was conclusive proof that no order had been received, then Mr. Gruber when he learned of the rate of cancellations as he did, would be chargeable with knowledge that the transactions were not really sales and should not be so recorded.

² Mr. Friedman's testimony was stipulated. No suggestion is made in the record that reflects on his credibility, and no contrary or impeaching testimony was produced.

and experienced employee of registrant, was immediately instructed by registrant's New York office that cancellations must be cut down.

Charles C. Kieffer, Esq. of the bar of this Court, who was registrant's attorney in Washington, D. C., instructed Mr. Friedman that every confirmation by any salesman must be checked by Mr. Friedman's personal telephone call to the customer the same day the order was received.

Mr. Friedman followed these instructions. All sales tickets were put on his desk and he made a telephone check of each one before he would permit a confirmation to be mailed (R. 127-8).

Yet, as even the Commission's opinion states, the rate of cancellations not only continued but increased in spite of this check (R. 199).

This record fact destroys any inference that the reason for the high rate of cancellations was due to misrepresentation on the part of the salesmen as to whether their customers had agreed to purchase stock in the first place. The clear and only acceptable inference is that the cancellations were caused by the fact that people who had actually purchased changed their minds and did not desire to carry out their agreement.¹

One misstatement in the opinion merits correction at this point. The opinion states (R. 199):

"We cannot accept the excuse that the false entries as to sales were due to the inexperience of the personnel at registrant's Washington office in view of Sacks' policy of advertising for and hiring only inexperienced salesmen, a policy which the record shows Gruber knew about from the very beginning."

Mr. Gruber did not attempt to excuse "false entries" as to sales on the ground of inexperience of salesmen. Instead, the Commission stipulated that (R. 121):

¹ Mr. Gruber finally resorted to written contracts and only then did his cancellations stop (R. 199).

"He [Gruber] attributed such high rate of cancellations [not false entries] to some extent to the numerous inexperienced personnel in his employ and to lack of supervision of Office Managers."

Based on the foregoing facts, we submit that the findings of the Commission that Mr. Gruber willfully violated the bookkeeping provisions of the Act in any manner or that he was the "cause" of any willful violations is clearly error. Accordingly, the Commission's order must be reversed.

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Although this conclusion without more is sufficient grounds for reversal if accepted by the Court, it is also clear that there is no substantial evidence on the whole record to show that any false book entries were in fact made.

As we have shown, two separate securities issues were involved in the Commission's charge of "false" entries: Perfect-Line Manufacturing Corporation and Century Controls Corporation. Inasmuch as the nature of the evidence introduced as to the handling of these two issues was quite different, they will be dealt with separately.

**B. There Was No Evidence Whatsoever Of
Improper Entries On The Perfect-Line
Sales.**

Although there was, as we have seen, a conflict of evidence on the verbal agreements reached by registrant's salesman and the customers on the sales of the Century Controls stock, there is no conflict of evidence on the sales of the Perfect-Line stock.

In fact, the Commission did not introduce any proof either by way of stipulation or by the testimony of live witnesses to establish that even one entry on the 795 sales of the Perfect-Line issue were improperly made. Yet the Commission specifically found (R. 197-8):

"The record established that during that period and thereafter until December 10, 1956, registrant engaged in a practice of mailing confirmations of sales of stock of Century Controls Corporation and Perfect-Line Manufacturing Corp. to persons whom registrant solicited to purchase such stock but who did not in fact agree to make the purchase." [Emphasis supplied]

We confess we did not understand this finding except on the improper assumption discussed above that a cancellation is conclusive proof that the customer did not order the stock in the first place.

C. There Was No Substantial Evidence Of
A "Practice" Of Improper Entries On
The Century Controls Stock.

As set out above, the Commission also found that registrant had "engaged" in the same "practice" of improper entries on Century Control stock.

However, as we have seen, the Commission with all its extensive investigation facilities was able to produce, by stipulated testimony, only 4 individuals out of the 502 who received confirmations of sale on the Century Control stock issue from registrant who claimed that they had not definitely agreed to purchase the stock prior to the receipt of such confirmations. The purport of their claim was that they had not agreed to purchase the stock, but had only agreed to receive a confirmation "to protect the stock".

Certainly this quantum of proof cannot be stretched to provide a basis for the Commission's finding that this was the regular course or "practice" followed by registrant's salesman. For, setting these four transactions aside for the moment, the clear and specific testimony of registrant's office salesmen under oath at the hearing is that the customers had in fact given firm orders before sales were confirmed to them.

With respect to the general practice, Mr. Zazicki testified (R. 77-8):

Q Did Mr. Sacks at any time tell you to write up a confirmation order unless you had a sale?

A No.

Q What exactly were his instructions?

A Well, never to, I guess you would call it, become overly strong over the telephone, never to high-pressure an individual when they showed interest.

Q Were you ever permitted to confirm a sale on speculation in the hope that by the time they got the brochure they would change their mind?

A No.

Q Would that be contrary to Mr. Sacks' instructions to you?

A Yes.

Oddly enough, the Commission, in its decision, makes no mention of this testimony or the testimony of Messrs. Sacks and Zazicki quoted in the statement of the case that the four customers had in fact agreed to purchase the stock. For all that the decision discloses this testimony was simply ignored.¹

Thus, based on this record, the "substantial evidence" "on the whole record" consists of

(a) Uncontradicted testimony that firm commitments were received before confirmations

¹ The Commission's finding that Sacks, one of the salesmen, had (R. 198) "personally sent a confirmation of sale to a customer (Mrs. Howell) whom he had solicited because she had expressed an interest in buying the stock although she had not actually agreed to buy" is not consistent with his testimony. Thus, Sacks testified (R. 42):

Q. At the conclusion of your conversation [with Mrs. Howell], did she indicate that she wanted to buy this stock?

A. Yes.

were mailed, or book entries of sale were made, on 498 out of 502 Century Control transactions and on all 795 Perfect-Line transactions.

(b) An unresolved conflict of testimony¹ as to whether firm commitments were received before confirmations were mailed, or book entries of sale were made, on the remaining 4 transactions.

(c) Uncontradicted testimony that registrant's employees were instructed to mail confirmations only after receipt of a firm purchase order.

Certainly "the solid sense of the entire record"² does not support the Commission's finding that "registrant engaged in a practice" of mailing confirmations and making book entries of sale without first securing firm purchase orders on the 502 Century Controls transactions. On the contrary, the record considered as a whole dictates a precisely opposite result. Pittsburgh S.S. Co. v. National Labor Relations Board, 180 F.2d 731 (6th Cir. 1950).

In Pittsburgh on a similar state of the record on divergent facts the Court held (at p. 742):

"We think that to ignore the complete absence of union trouble on 66 ships [conflicts occurred on 7 others] where the positive instructions were that the rights of the men should be protected and where the basis of the

¹ This conflict was between the live testimony of registrant's salesmen who were on the stand and subject to cross-examination and the stipulated testimony of four customers, who were not subject to cross-examination. The customers would have been subject to an obvious bias because if they did not testify that they refused to buy the stock they would have been financially liable. The Commission's counsel could not have had too much confidence in these witnesses or he would have produced them.

² Victor Products Corp. v. National Labor Relations Board, ___ App. D. C. ___, 208 F.2d 834, 839 (1953).

holding against the employer is that it engaged in a general course of anti-union conduct, is to ignore the mandate of the two statutes [Taft-Hartley & Administrative Procedure Act] that decision shall be based upon 'the record considered as a whole'." (Emphasis supplied)

So here. The record considered as a whole cannot possibly support the Commission's finding of a 'practice' of false entries where only four transactions out of a total of almost 1300 were disputed.

D. The Commission's Total Disregard
Of Sacks' and Zazicki's Testimony
On The Century Controls Sales Was
Reversible Error.

As we have shown, registrant's salesmen, Sacks and Zazicki, testified that (a) the regular practice of registrant was to mail confirmations and make book entries of sales only after purchase commitments were received, and (b) they had received firm orders before sending confirmations and making book entries of sales in the four disputed Century Controls transactions.

As we have also shown, the Commission made no mention of this contradictory testimony in its decision. For all that the decision discloses this testimony was simply ignored. This was clearly in error. For it is clear under Section 7(c) of the Administrative Procedure Act¹ that:

"no sanction shall be imposed or rule or order issued except upon consideration of the whole record or such portions thereof as may be cited by any party and as supported by and in accordance with the reliable, probative and substantial evidence."

Consideration of the 'whole record' requires [Universal Camera Corp. v. National Labor Relations Board, 340 U. S. 474, 487 (1951)]:

¹ 60 Stat. 243 (1946), 5 U. S. C. 1006(c).

"taking into account contradictory evidence or evidence from which conflicting inferences could be drawn."¹

This the Commission did not do. In fact the Commission did not even mention in its decision the fact that there was conflicting testimony on the Century Controls transactions. Mr. Zazicki, registrant's salesman who testified that definite purchase commitments were received and recorded in three of the four contested transactions, was completely ignored in the Commission's decisional process: Neither his name nor his testimony were elevated to even the level of a footnote.

If the Commission did not credit his crucial testimony it was required to say so and explain why in proper findings. For without findings, there is no way in which the 'parties or the reviewing tribunal may determine whether the case has been decided upon the evidence and the law or, on the contrary, upon arbitrary considerations . . . it is to insure against Star Chamber methods [that findings are required]".

Saginaw Broadcasting Co. v. Federal Communications Commission, 68 App. D.C. 282, 96 F.2d 554, 559 (1939).

**E. No Improper Bookkeeping Has Been
Shown Even On The Testimony Of
The Investor Witnesses.**

Even if the testimony of registrant's witnesses is wholly ignored, and the stipulated testimony of the 4 customers is accepted, there still is no rational basis for finding that the four Century Controls transactions involved false and fictitious entries.

The stipulated testimony is that the customers agreed that registrant's salesmen should mail them a confirmation of purchase of stock,

¹ Or, stated conversely, Section 7(c) precludes "the consideration of only one part or one side of the case." Pittsburgh S. S. Co. v. National Labor Relations Board, 180 F.2d 731 (6th Cir. 1950).

that this confirmation would bind the corporation to sell the stock, but that the customer would not be bound to accept it.

It was not claimed by the Commission in its order, at trial, or even in argument of counsel, that it is illegal or fraudulent in any way for a broker to send a confirmation of sale, with the customer's consent, to a customer who has not, in fact, agreed to purchase. In substance, such a transaction, giving the customer a right to purchase or to reject, would be a sale on approval. It is no different in substance from an order for furniture from a department store to see how it looks in the house, before deciding whether to keep it or to return it. This the Commission does not disagree with. It does not challenge the legality of the transaction.¹ Its wisdom as a business matter, or indeed its ethics, which to us seem above reproach, are not matters with which the Commission may properly concern itself.

The only objection that the Commission makes is that when such a perfectly legal transaction has been made that it is a false and fictitious entry for the broker to enter the transaction on its books as a sale.

On the assumptions made, the broker was obligated to sell but the customer was not obligated to purchase. The Commission takes the position that the transaction should not be entered immediately as a sale. Presumably it feels that the transaction should be held in suspense until the customer replied by payment or otherwise.

¹ At the oral argument before the Commission the following colloquy took place (R. 218):

Acting Chairman Orrick: Do you consider that the sending of confirmations of purchases where in fact no transaction was ordered by the customer constituted fraud?

Mr. Cuvillo: No, sir. The allegation here is that the writing up of the confirmation and the subsequent taking of the information from that confirmation and entering it onto the original books of entry of the registrant constituted false entries on those books.

It seems to us that there is no basis whatever for regarding the treatment adopted as one of false and fictitious entries. Indeed, had the bookkeeping practice been followed of not entering the transaction until the customer either paid or cancelled, the Commission could, with more justice, have complained that the records of the company were inadequate in failing to reflect an obligation on its part to sell the securities confirmed to the customer. The Commission points to no ruling, interpretation or authority that the method chosen is not appropriate for treating such a transaction. It merely, without more, applies the epithet "false and fictitious". The record contains no evidence to sustain such an appellation and the Commission's opinion points to none.

Certainly the statute, Section 17(a) of the Securities Exchange Act, which only requires that a dealer keep such books, accounts and other papers as the Commission by rule may require, and the rule thereunder, Section 17a-3(a) (7), which requires only a memorandum of each purchase and sale of securities, does not provide any authority for the Commission's finding.

On the contrary, the immediate entry of all transactions seems to be the end which the Commission seeks. Thus, Rule 17a-3(a) (7) requires "a memorandum of each purchase and sale of securities for the account of such member, broker or dealer showing the price and, to the extent feasible, the time of execution". Under this rule, the Commission has informed all brokers and dealers, by an administrative ruling, that prompt entries are required.¹

¹ See Exch. Act Release 3040, 10/31/41, as follows:

The phrase "to the extent feasible" in sub-paragraph (a) (7) of this rule was intended to be applicable only in exceptional circumstances where it might be actually impossible to determine the exact time of execution. Our experience has demonstrated that it is in fact possible to keep the times of so-called "trading transactions". Also, a transaction is "executed" within the meaning of the rule when the contract to sell or purchase is entered into by the person authorized to effect transactions for the account of the firm.

A firm should take prompt steps to insure the recording of the times of all transactions executed by its trading department as well as all other transactions. Even where it may be physically impossible to determine the precise time, at least the approximate time must be noted.

This insistence on immediate entry of all transactions was, to the best of their ability, followed by registrant's employees in a rational and understandable manner. Certainly no violation of the Act or the Rules resulted. In this regard, the Second Circuit in Wright v. Securities & Exchange Commission, 112 F.2d 89, 93-4 (1940), has pointed out that the provisions of the Act "must be strictly construed since a violation of it may be punished as a crime." (Emphasis supplied) Certainly a proper construction of the subject statute and rule affords no rational basis for a finding of "false and fictitious" entries.¹

III. THE COMMISSION FAILED TO MAKE PROPER FINDINGS TO SUPPORT ITS CONCLUSIONS THAT A DENIAL WAS NECESSARY TO PROTECT THE PUBLIC INTEREST.

As we have shown, the Commission plainly erred in its finding that Gruber willfully violated the registration and bookkeeping provisions of the statutes. On this ground alone the Commission decision must be reversed. Norris & Hirshberg v. Securities & Exchange Commission, supra.

As a consequence, this Court need not reach the question of whether the denial order was necessary to protect the public interest. However, assuming for purposes of argument that the Court can find adequate support for the Commission's findings of willful violations by Gruber, we submit that the Commission's order must be reversed because of its groundless and wholly arbitrary application of the public interest standard.

As this Court is aware the Commission has no power to deny an application as here on the sole ground that the applicant has willfully violated applicable statutes.

¹ Under the Act the term "security" is defined to include the "right to subscribe to or purchase" stock. Section 3(a)(10), 48 Stat. 882 (1934), 15 U.S.C. §78c(a)(10).

Section 15 (b) of the Securities Act expressly provides that in addition to the necessary finding of a willful violation, the Commission must also find that denial of the application is in the public interest. Thus, as stated in the Pierce case, supra, the power to deny a broker application cannot be exercised as a "penalty ... on the broker. To the contrary, it is but a means to protect the public interest." [239 F.2d at 163] In other words, as with any exercise of administrative discretion, the Commission must be reversed if it exercises its powers in an arbitrary and capricious manner. Cf. Broadcasting Service Organization v. Federal Communications Commission, supra, 171 F.2d at 1015.

As we shall now show the Commission's exercise of its powers in this case was arbitrary, for it failed to make adequate findings to support its conclusion that a denial was necessary to protect either the public or the Commission's functions:

The Acoustica Sales, The Registration Violation.

After referring to some of the facts surrounding this technical violation, facts which establish that Mr. Gruber was in no way responsible for the violation (i.e. his strict instructions as to compliance with law, his absence from the country, and the small number of allegedly improper sales--4 out of 144), the Commission made one cryptic statement on which it based its public interest conclusion that the broker application should be denied (R. 199):

"The registration ... requirements of the securities laws must be fully observed if investors are to receive the full disclosure to which they are entitled..."

Clearly this single statement did not discharge the Commission's obligation to advise the registrant and the Court why it believes the failure to comply with the statute in 4 out of 144 cases makes it in the public interest to deny registration when investors profited substantially in the transaction. This Court has repeatedly held that it cannot carry

out its statutory duty of administrative review unless it has before it a full statement of the reasons for the agency's conclusions. Telanserphone, Inc. v. Federal Communications Commission, *supra*, 231 F.2d at 735; Capital Transit Co. v. Public Utilities Commission, *supra*, 213 F.2d at 183, and cases cited. Certainly, the Commission did not supply a statement adequate to satisfy the test laid down by this Court.

On the other hand, if the Commission had no further basis on which to base its public interest determination, its decision must be struck down as arbitrary and capricious. The quoted Commission language can only mean that any failure to comply with the law even of a technical nature, such as the one here involved, and even though the investors make money, is to be regarded in the light of the "public interest" standards the same as a deliberate concealment of facts greatly injurious to investors.

Such a conclusion cannot be sustained. As this Court stated in Broadcasting Service Organization v. Federal Communications Commission, 84 App. D.C. 152, 171 F.2d at 1014-15:

"Here there is no substantial evidence of any heedlessness and it is conceded that there have been and can be no harmful consequences flowing either to the Commission or to the public interest as a result of appellant's [actions] . . .

[T]he Commission, and this court on review, must constantly be guided by the prevailing purpose of the . . . Act in ascertaining the result in each case which will best serve the public interest. In such a determination there is no place for the arbitrary application of pointless technicality unsupported by substantial evidence."

The Bookkeeping Charges: The Commission's reasoning under this charge is similarly defective. After brushing aside, without answer, Gruber's assertion that no customers were harmed by the high rate of cancellations on the Perfect-Line and Century Controls issues,

and the further crucial fact that he had never before been the subject of disciplinary proceedings in connection with the securities business, the Commission stated that the (R. 199):

"record-keeping requirements of the securities laws must be fully observed if . . . we are to be able to rely on the records of brokers and dealers in performing our functions under the Exchange Act."

We agree that the Commission should be able to rely on broker records. However, when the Commission decides that a particular practice is a ground for revocation of a broker-dealer license, it must show that the practice complained of would actually or possibly interfere with the Commission's functions or be injurious to the public. Otherwise, any inconsequential deviation from the record-keeping regulations would be a ground for barring a broker or dealer from business.

Accordingly, before it can exercise its power to destroy a broker's livelihood, the Commission must find that the particular method of record-keeping has concealed or is likely to conceal a practice which may be injurious in fact to the enforcement of the Commission's functions or to the interest of investors. This the Commission did not do. Without such a finding, the denial of registrant's application is a clear abuse of discretion. We believe that the necessary finding was not made, simply because it could not be rationally applied to the facts. We say this because we cannot conceive of (conceding, for argument, all that the Commission claims) how the entry of sales on registrant's books, where the sale was on condition and subject to approval by the prospective purchaser, could possibly be injurious to the Commission's functions or to investors. Further, the Commission readily concedes, in fact insists, that all cancellations of such sales were promptly entered on registrant's books.

The Consent Injunction: Another step in the Commission's enunciation of factors bearing on the bookkeeping charges was so arbitrary and unusual as to require special comment. Thus, the Commission used a consent injunction entered in the Southern District of New York as additional grounds for its action against Mr. Gruber and the applicant. This was highly improper and grounds for reversal in and of itself.

The Commission's findings were as follows (R. 200):

"We note further that registrant, Gruber and Sacks admit that a preliminary injunction, based upon charges of violations of the record-keeping rules and involving the same bookkeeping entries, was entered on January 7, 1957 by the United States District Court for the Southern District of New York with the consent of registrant and Gruber and on default by Sacks, enjoining each of them from making false and misleading entries in registrant's books and records pending a decision on the merits of those charges.

Under all the circumstances, we think it necessary and appropriate in the public interest that applicant's application for registration as a broker and dealer be denied, and to deny applicant's request for withdrawal of its application for registration. We further conclude that Gruber and Sacks are each a cause of the order entered herein denying the application."

The injunction referred to was issued on a suit by the Securities and Exchange Commission against registrant corporation, Mr. Gruber and Mr. Sacks, arising out of the same bookkeeping charge here considered. The injunction suit was filed while this proceeding was pending before the Commission. Understandably not anxious to litigate the same question in two forums at the same time, and since he had not and did not intend to engage in the practices forbidden, petitioner Gruber consented to the injunction until trial. Section 15 (b) of the Securities Exchange Act makes the granting of a preliminary injunction a ground for revocation, which we assume might also apply to injunction obtained

by consent. However, the consent of Mr. Gruber was, as set out in the injunction, and as endorsed on the papers by Judge Palmieri, specifically "... on condition that matters in the complaint will not form basis of revocation proceedings by the S.E.C. (§15(b)) between date of temporary injunction and the trial of action ..."¹

The Commission will concede that no trial of the Court action had taken place at the time of its order of January, 1958 nor indeed as of this date.

The Commission was, of course, fully familiar with the condition attached to the injunction and the Court's notation thereon, for the Commission itself brought and prosecuted the injunctive action. The only charitable construction that can be put on the entry of the Commission's highly improper findings on the injunction in the present proceeding, is that it suffered an astounding lapse of official memory.

Certainly the only relevancy of the injunction was that an adequate impartial forum existed for the trial of the charges here considered and that no ground therefore existed for the Commission's proceedings until the New York case was decided on the merits. The Commission should be admonished that its reference to the injunction as adverse to petitioner was highly improper under the circumstances and a violation of its commitments to the District Court.

CONCLUSION

For the reasons herein stated, the Commission's final decision and order of January 15, 1958 is contrary to law. Accordingly, the Commission should be reversed and the case remanded to the Commission with directions (1) to reverse its denial of P. J. Gruber & Co., Inc.'s

¹ A copy of the notation by Judge Palmieri has been attached as a part of this brief.

application for registration as a broker-dealer, (2) to reverse its denial of the request for withdrawal of such application, and (3) to reverse its findings of willful violations of the Securities laws and the Commission's rules by Mr. Gruber.

Respectfully submitted,

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December 9, 1958.

SOUTHERN District of NEW YORK

SECURITIES AND EXCHANGE COMMISSION

Plaintiff,

v.

P. J. CHUBER & CO., INC.,
PETER J. CHUBER, and
PHIL SACKS,

Defendants.

PROOF OF SERVICE

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Regional Administrator
WILLIAM D. MORAN
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Borough of Manhattan
City of New York 4, N. Y.

Preliminary injunction
by SS Chubers
Consented to by me
Condition about matters
alleged in complaint
will not form basis
of revocation
proceeding by S.E.C.
(§15b) between
date of temporary
injunction
and trial of action.

S. W. Palmer
Dec 18/56

motion for preliminary
injunction granted
by default as against
defendant Sacks

S. W. Palmer
Dec 18/56

REPLY BRIEF FOR PETITIONERS

United States Court of Appeals

FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 14,381

P. J. GRUBER AND COMPANY, INC.,
AND PETER J. GRUBER,

Petitioners,

v.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

ON PETITION FOR REVIEW FROM ORDER OF THE
SECURITIES AND EXCHANGE COMMISSION

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Columbia Circuit

MAR - 2 1959

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UNITED STATES COURT OF APPEALS
For The District Of Columbia Circuit

No. 14,381

P. J. GRUBER AND COMPANY, INC.,
AND PETER J. GRUBER,

Petitioners,

v.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

ON PETITION FOR REVIEW FROM ORDER OF THE
SECURITIES AND EXCHANGE COMMISSION

REPLY BRIEF FOR PETITIONERS

I. MR. GRUBER DID NOT PERSONALLY VIOLATE THE SECURITIES
LAWS EITHER WILLFULLY OR OTHERWISE

The Commission's brief concedes all that is necessary to show that reversal is required here. It argues that Mr. Gruber personally "willfully violated" the securities laws by reason of acts which he did not do, which he did not cause to be done, and which he had no reason to believe would be done.

The Commission does not deny the basic legal principle that the question here is one of Mr. Gruber's individual and personal responsibility. It seeks, however, to obscure this fact. It is therefore necessary

to repeat that under Section 15(b) of the Securities Exchange Act the Commission had no right to deny registration to the Delaware corporation unless Mr. Gruber personally had willfully violated the Securities Act and the Exchange Act. The Commission's opinion finds that he did so personally and willfully violate the Act. That finding plainly cannot stand.

No evidence is brought forward in the Commission's brief to show any basis whatsoever for supporting any inference that Mr. Gruber had any responsibility for the acts alleged to have been violations of law. It is not even charged that he did the acts himself, or knew that they were being done, or would be done. And, no evidence was produced to show that he had any reason to believe that they were being, or would be done.

There are two charges, (1) the sale of Acoustica shares and (2) the bookkeeping charge.

(1) It is conceded (a) that Mr. Gruber directed the employees of his New York company to sell shares of Acoustica stock only to residents of the State of New York, (b) that what he directed his employees to do was legal, and (c) that he had no reason to believe that they would not follow his instructions.

(2) It is clear that the employees of Mr. Gruber's company were directed to confirm sales of stock only when they had received actual orders from customers. (R. 77-8) It is conceded that Mr. Gruber did not know, if it was indeed the fact, that any confirmations were made contrary to these instructions. The only argument the Commission makes in its brief is that Mr. Gruber should have known that sales were made without orders because of the high rate of cancellations. The fact, however, is that the record conclusively establishes that the high rate of cancellations resulted from the unwillingness of customers to take shares they had actually ordered, rather than that the shares had not been ordered. Therefore, it is clear that there is no basis for charging Mr.

Gruber with willfully violating the securities laws as found in the Commission's opinion.

The Commission seeks to obscure this fact by citing cases which hold that persons who do, intentionally and deliberately, an act which is in violation of law may be held to have willfully violated the law even if they do not know or believe that the act violates the law in question. (p. 14) We do not doubt the validity of these cases. However, they are inapplicable here because Mr. Gruber did not himself do any of these acts. Of course if he caused them to be done he would be equally responsible as though he had done them himself. But he did not cause them to be done and the Commission does not say he did. Further, he had no reason to believe they would be done. The Johnson case cited by the Commission, Johnson v. S.E.C., 198 F. 2d 690 (2d Cir. 1952), does not apply for there Johnson had every reason to believe violations were taking place and "recklessly" did nothing to stop them. Here there is no evidence at all that Mr. Gruber had any reason to believe a violation of law was taking place. Since therefore Mr. Gruber had no responsibility for the acts, if those acts are violations of law, they are not his violations of law at all. Consequently, they cannot be "willful" violations of law by him. That being the case, there is no basis for the Commission's finding of willful violation by Mr. Gruber personally which is concededly essential to sustain the action taken by the Commission.

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Some further analysis of the Commission's argumentation will help to illuminate this basic fact.

II. THE ACOUSTICA SALES

It is charged that Mr. Gruber willfully violated the registration provisions of Section 5 of the Securities Act in selling shares of Acoustica Corporation without registration.

The Commission concedes that Mr. Gruber instructed the sales to be made only to residents of the state of New York, and that such a course of action would be lawful. Its brief states at page 12:

"If all his instructions had been obeyed Gruber would, at least in this regard, have been in a position to claim the availability of the exemption he originally anticipated. The fact is that his instructions were not obeyed."

Despite this concession which is in accord with the record, the Commission repeatedly seeks to imply the contrary. Thus, at pages 7, 9, 11 and 12 of the brief the Commission states that the Acoustica shares were "sold pursuant to his [Mr. Gruber's] directions", without saying that the four sales which were made to non-residents were made contrary to his directions.¹

Concededly, Mr. Gruber gave instructions to make sales only to residents of the state of New York. He had every reason to believe his instructions were given to reliable persons who would carry them out. (See principal brief, pp. 24-5) The instructions were, in fact, carried out in 140 out of 144 sales. (R. 135)² Mr. Gruber was out of the country at the time of the sales (R. 119-20) and upon his return and upon finding out that his instructions had not been obeyed, he gave immediate consideration to corrective action. (R. 120) But no such corrective action was appropriate since investors had not only not been damaged, but had a substantial profit on the shares in question.

¹ Cf. also p. 11 Mr. "Gruber does not deny that all these sales then were intentional and willful and made under his instructions."

² The Commission, in footnote 8 on page 12, seems to prefer the view that the salesmen in making the four out-of-state sales did not inadvertently violate Mr. Gruber's instructions but did so willfully and deliberately, and urges that we are precluded from making a contrary argument. The view that the salesmen willfully violated the instructions, as the Commission urges, merely emphasizes that Mr. Gruber cannot be held responsible for the actions of the salesmen. For of course willful disobedience of his instructions was much less to be anticipated by Mr. Gruber and much less to be attributed to him.

Plainly, Mr. Gruber had no responsibility for sales made in violation of his instructions. He did all he could to direct and see to compliance with the law and it is an impossible distortion of fact and law to say that he personally violated the Securities Act at all and much more so to accuse him of "willful" violation.

III. THE SUPPOSED BOOKKEEPING VIOLATIONS

Mr. Gruber is charged with entering sales of stock on the books of his New York company when the Commission charges the supposed purchaser had not in fact agreed to buy. This the Commission says is a willful violation by Mr. Gruber of its rules requiring sales to be recorded.

Commission counsel, in their brief, nowhere challenges the assertions made in our principal brief (pp. 22-4), that if confirmations were in fact sent out where customers had not ordered the securities, Mr. Gruber was himself not a party to the transactions, that he never talked to the customers in question, that the customers talked only to salesmen and that no salesman advised Mr. Gruber that sales not supported by actual agreement were being reported. The basis for the Commission's argument is not that Mr. Gruber did these acts, or directed them, or knew of them, but only that he should have known that such acts were taking place because there were a great many cancellations of orders. This, again, is true only if the cancellation of an order is taken as conclusive proof that the order was not given in the first place. As established on pages 24 to 26 of our principal brief, the record is absolutely clear that the high rate of cancellations continued even after an independent telephone check was made by a clerk of every order before confirmations were sent out. It is thus conclusively established on the record that the cancellations were caused by the fact that people who had

actually purchased in telephone conversations, changed their minds and did not desire to carry out their agreements.¹

The Commission's argument that the high rate of cancellations should have been notice to Mr. Gruber that the sales were not supported by orders is thus conclusively refuted by the record. There remains no basis for holding that Mr. Gruber was in any way responsible, if any confirmations were in fact sent out improperly and recorded on the books as sales.

The Commission's only argument is that Gruber did not adequately supervise the salesmen and is guilty of any violations on their part, citing the Johnson case (pp. 20, 21).² Had there been evidence such as was present in Johnson of reckless disregard by an employer of known facts, amounting to encouragement of violations by salesmen we would agree.

¹ The Commission (pp. 15 and 16) makes a point that we say that only four transactions are in question and that the stipulation says four named persons "and others" would testify that confirmations were sent although they had not ordered. We do not understand what effect the stipulation has that unnamed others would so testify, particularly in view of the fact of specific denial by the salesmen in question that they had ever sent confirmations where the purchaser had not agreed to purchase (R. 77-8). We believe this point has no value. Cf. the fact that although counsel does not dare equate "others" with "many others" they suggest that "others" may include "any" of the 191 sales of Century Controls stock. See also the fact that the Commission stipulated that an unspecified number of "other" investor witnesses would testify to agreement to purchase the shares and satisfaction with the purchase (R. 116-7). But certainly whether there were four or more such transactions does not affect the fact that Mr. Gruber had no responsibility for the transactions, did not engage in them himself, and did not have any reason to believe that anyone else was engaging in such transactions.

² The Commission also seems to argue that Mr. Gruber personally should be held responsible for whatever violations of law there may be in companies that he controls no matter how innocent he may be. The Commission says this is because the salesmen cannot be held responsible (see p. 13), and suggests that registrants engaged in the securities business must shoulder the responsibility for the conduct of their salesmen. This is not the fact. Since the Wallach case, cited at p. 13, the Commission has followed an only slightly different practice of making salesmen and other employees parties to proceedings, as they did Mr. Gruber himself and Mr. Sacks in the very proceeding before this Court. See also Loss, Securities Reg., 1955 Suppl. p. 731. Mr. Gruber is responsible under the statute only for what he did himself, what he caused to be done knowingly, or what he knew or had reason to believe was being done and as in Johnson "recklessly" refused to prevent.

But here there is no scintilla of such evidence. As we have shown, Gruber had no knowledge or reason to believe impropriety existed, so he cannot be accused of recklessness or other participation in a known or even reasonably expected violation by a salesman.¹

In establishing the innocence of Mr. Gruber, we have shown the Commission's finding and order to be baseless. Nothing more is required. We shall, however, deal below with some of the Commission's arguments on the alternative points.

IV. MISCELLANEOUS ARGUMENTS OF THE COMMISSION

A. The Supposed Bookkeeping Violation

1. Perfect Line Sales

On pages 26 and 27 of our principal brief we pointed out that the Commission's finding of bookkeeping impropriety in these sales is without any support in the record. The Commission's answer (Br. p. 19) does not deny this fact, but relies on some mysterious "experience" unsupported by the record. In substance, it says if there is evidence (which as we shall see there is not) of bookkeeping impropriety in one stock, the Commission is "justified" without evidence "in drawing the inference" that it occurred also in another stock. We do not so understand the law. Further, there is no evidence that sales of the other stock, Century Controls, were improperly entered on the books.

2. Century Controls Sales

The Salesmen Witnesses

1. Of course, as we have shown in our principal brief (pp. 27-31), the four investor witnesses whose testimony was stipulated were contradicted under oath by the salesmen. The Commission's brief (following

¹ We apologize to the court for citing this Court's decision in Broadcasting Service Organization v. Federal Communications Commission, 84 App. D. C. 152, 171 F. 2d 1007 (1948) since this decision was reversed at 337 U. S. 901 (1949) by the Supreme Court, per curiam, without opinion, citing Federal Communications Commission v. WOKO, Inc., 329 U. S. 223.

the Commission opinion in this respect) ignores this fact and offers no rationale to support the rejection of the salesmen's sworn testimony. As we pointed out in our principal brief (pp. 27-31), this was and is error, and it now stands as undefended error.¹

2. Even on the investors' testimony, as shown on pages 31-34 of our principal brief, no bookkeeping error was shown. The Commission's brief argues

(a) That some unspecified number more than 4 transactions out of one thousand were made without full authorization. This is not permissible in the face of only four stipulated witnesses. Certainly there is no basis for extending the "and others" phrase in the stipulation to be so general as to talk of a "practice" or to say that salesmen "were sending out confirmations" (Br. p. 16), or talk of "the very great number of false entries" (p. 19). Compare the fact that the Commission agrees (R. 116-7) that "other" investor witnesses would testify to complete satisfaction with their transactions and proper confirmation. Nor is there any basis in the record whatsoever for the statement in their brief that the confirmations were sent "in the hope that the customer would think he was bound to purchase the stock". (p. 16) This is pure invention by counsel.

(b) On the assumption (not the "admitted facts" as the Commission calls them (Br. p. 17)) that the investor witnesses are to be believed rather than the salesmen, the Commission says the confirmations and succeeding entries were false. The assumed facts then are that the brokerage house was bound but the investor was not -- in substance the investor had an option. The Commission says this is a "novel theory" but does not seek to deny that this is the effect of the stipulated investor

¹ It is, of course, not true as the Commission's brief states (p. 16, fn. 13) that we accept their rejection of the salesmen's testimony. How this statement could be used in the face of pp. 27-31 of our principal brief we do not understand. Of course, in subsequent arguments we show that the Commission is in further error even if we assume arguendo that it could properly accept the investors' stipulated testimony in the face of the salesmen's sworn testimony.

testimony on which it relies, i.e., that the confirmation was to be issued "to protect the stock" for the investor. Then it says without support, that such an option, if recorded as a sale, is false and fictitious (Br. 16). It says nothing of how such a transaction is to be treated on the sales records. It does not answer the question raised in our principal brief (pp. 32-33) of whether the transaction should be omitted or held in suspense until the option is exercised, and if so, how this is to be reconciled with the Commission's repeated emphasis on immediate recordation of transactions. On the assumptions made, plainly the bookkeeping practice followed was permissible, and in the absence of a Commission rule specifically requiring a different treatment, cannot be condemned as false and fictitious by mere unexplained and unjustified assertion.

3. The Commission seeks to magnify the importance of the treatment of these few transactions by suggesting that erroneous bookkeeping might conceal insolvency. The suggestion in this context is unworthy of the Commission. There is no syllable of evidence or suggestion of insolvency in the record here or elsewhere. The New York brokerage house, in continuous operation since 1954, has been subject to periodic examination by the Commission in addition to the investigation incident to the present order, and its solvency and compliance with the Commission's net capital requirements are adequately proved by these inquiries.¹

4. The Commission makes much point of the fact that cancellations ceased after written verification proceedings were adopted. (Br. p. 17) Of course, it may be expected that customers who have responded to a letter and confirmed in writing that they had purchased securities would be less apt to seek to cancel the transactions than persons who had merely agreed to the purchases on the telephone. The suggestion that the verification procedures by telephone, by independent clerical employees were

¹ In addition, the particular form of suggested injury to the public is inapplicable here. The example chosen by counsel relates to a required deduction in the value of "all unsold securities held by the broker dealer..." As the Commission's own files, but not this record, will show, for the most part these securities were not "held" by registrant, but sold as an agent.

"grossly ineffective", is without evidence. It proceeds on the same false assumption, conclusively refuted in the record as we have noted, that a cancellation necessarily means that the customer did not order the shares, rather than that he had changed his mind after ordering the shares.

3. Public Interest

As we have pointed out, no discussion of public interest whatsoever occurs in the Commission's opinion except the improper discussion of the consent injunction in violation of the terms of that order.

(a) Counsel candidly admits that the Commission was not aware of the restriction imposed on its use of the consent injunction. This candor is, however, marred by the suggestion that, if the Commission had known of the restriction, it would nevertheless have felt free to refer to the injunction. Counsel argue that the New York court's prohibition against the Commission's use of the consent order in "revocation proceedings by the S.E.C. (Section 15(b))" might be construed not to include denial proceedings under the same Section 15(b). We prefer to believe that in the interest of both necessity and fair dealing with the court and the petitioners, the Commission would have consulted petitioners and the court before it took such a restrictive view of the court's prohibition.¹

The Commission's discussion of public interest as pointed out is absolutely lacking in a description of the reasons why sanctions should be imposed because of a sale of securities such as Acoustica in which investors made a good deal of money, or bookkeeping errors when there is no possibility of resulting injury to the carrying out of the Commission's functions or to the interest of investors. By so doing the Commission has not only failed in its statutory obligation but failed to supply this

¹ No mention of the restriction was placed in the stipulation by the petitioners because it was inconceivable to them that the consent injunction would be used against them here. The pending injunction is properly in the case only as an indication that there is no public interest in denial since all questions could be resolved in court.

Court with a basis for carrying out its review functions. (See principal brief, p. 36)

In contrast, in the recent case of Carl M. Loeb, Rhoades & Co., SEA Release No. 5870, February 9, 1959, the Commission discussed fully the public interest. It there found what it called a serious willful violation of law, and explained in detail why no penalty was appropriate. That discussion is attached as an appendix to this brief.

We suggest that had the Commission given the present matter the same careful consideration, it could only have arrived at the same conclusion. We further suggest that independently of the conclusion arrived at, the Loeb Rhoades opinion shows by contrast that the Commission in the present case did not meet its obligation to inform this Court of the reasons why it believed the action against petitioners was necessary so that appropriate review could be made by this Court. (See principal brief, pp. 34-6)

CONCLUSION

The Commission's final decision and order of January 15, 1958 is contrary to law. Accordingly, the Commission should be reversed and the case remanded to the Commission with directions (1) to reverse its denial of P. J. Gruber & Co., Inc.'s application for registration as a broker-dealer, (2) to reverse its denial of the request for withdrawal of such application, and (3) to reverse its findings of willful violations of the Securities laws and the Commission's rules by Mr. Gruber.

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March 2, 1959

APPENDIX

DISCUSSION OF PUBLIC INTEREST
IN LOEB, RHOADES CASE

The Public Interest

Since we have found willful violations of the Securities Act, we must consider whether it is in the public interest or necessary or appropriate for the protection of investors to revoke the registration of either registrant or to suspend or expel either of them from membership in the NASD. In such inquiry our concern is not only with the gravity of the violations but primarily whether under all the circumstances the public interest or investor protection calls for elimination of registrants from the securities business or their permanent or temporary exclusion from the NASD.

For the reasons discussed above we believe the violations were serious, since practices such as these may subvert to a substantial degree the essential objective of the Securities Act that investors and dealers should have the opportunity to make investment decisions upon the basis of adequate information fully disclosed under statutory standards and sanctions.

However, we have taken into account a number of mitigating factors. Registrants bear an excellent general reputation in the securities business and have never before been the subject of disciplinary proceedings by us. The Court has found that they acted in good faith and in reliance upon the opinion of counsel. These proceedings and the judgment of the Court in the injunctive action we commenced have served to place registrants and the securities industry upon unmistakable notice of their obligations in the field of publicity and forcibly to direct the attention of registrants to the consequences of

improper practices in this area. There is no evidence of injury to investors since the publicity attendant upon our actions and the steps taken to disseminate the facts disclosed in the registration statement, particularly to those investors who had previously evidenced an interest, should have been adequate to dispel the effect of the unlawful release. We therefore conclude that the public interest and the protection of investors do not require that the registrations of registrants as brokers and dealers be revoked or that they be suspended or expelled from membership in the NASD.

By the Commission (Chairman Gadsby and Commissioners Orrick, Patterson, Hastings, and Sargent).

Orval L. DuBois
Secretary

343

BRIEF FOR RESPONDENT

United States Court of Appeals

FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 14,381

P. J. GRUBER AND COMPANY, INC., AND
PETER J. GRUBER, PETITIONERS

v.

SECURITIES AND EXCHANGE COMMISSION, RESPONDENT

ON PETITION FOR REVIEW OF AN ORDER OF THE SECURITIES AND EXCHANGE COMMISSION

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United States Court of Appeals
For the
District of Columbia Circuit

FILED

JAN 30 1959

Joseph W. Stewart
CLERK

COUNTERSTATEMENT OF QUESTIONS PRESENTED

I. Whether the Commission correctly concluded that Gruber wilfully violated Section 5(a) of the Securities Act.

II. Whether the Commission correctly concluded that Gruber wilfully violated Section 17(a) of the Securities Exchange Act and Rule 17a-3 thereunder.

III. Whether the Commission abused its discretion in concluding that it was in the public interest to deny applicant's registration.

(1)

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United States Court of Appeals

FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 14,381

P. J. GRUBER AND COMPANY, INC., AND
PETER J. GRUBER, PETITIONERS

v.

SECURITIES AND EXCHANGE COMMISSION, RESPONDENT

ON PETITION FOR REVIEW OF AN ORDER OF THE SECURITIES AND EXCHANGE COMMISSION

BRIEF FOR RESPONDENT

COUNTERSTATEMENT OF THE CASE

Petitioners, P. J. Gruber and Company, Inc. and Peter J. Gruber, seek to review an order of the Securities and Exchange Commission (the "Commission") denying P. J. Gruber & Co., Inc. registration as a broker and dealer in securities under Section 15(b) of the Securities Exchange Act of 1934, 15 U.S.C. Sec. 78o(b). The Commission found that petitioner P. J. Gruber had previously willfully violated the Securities Act of 1933 ("Securities Act"), 15 U.S.C. Sec. 77a *et seq.*, and the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. Sec. 78a *et seq.*; that it would be contrary to the public interest to permit the petitioners' application for registration to become effective, and that P. J. Gruber and one Phil Sacks were each a cause of the denial of the registration.

1. Statutes involved

The Securities Exchange Act of 1934 provides, among other things, for regulation of securities brokers and dealers in order to protect investors against improper and fraudulent conduct. In order to protect investors against abuse, the statute provides generally for exclusion from the securities business of persons responsible for certain misconduct, subject to a finding by the Commission with respect to the "public interest."

Section 15(a) of the Exchange Act, 15 U.S.C. Sec. 78o(a), requires prior registration with the Commission of everyone who acts as a broker or dealer in securities in the over-the-counter market (other than in an exclusively intrastate business or with respect to certain exempted securities not involved here) and who uses the mails or instrumentalities of interstate commerce in his transactions. Registration is effected through an application filed with the Commission pursuant to Section 15(b) of that Act, 15 U.S.C. Sec. 78o(b). That section requires denial of registration if the Commission finds after notice and opportunity for hearing, (1) that the applicant or any partner, officer, director, branch manager, or any person directly or indirectly controlling or controlled by such applicant, whether prior to or subsequent to becoming such, *inter alia*, has willfully violated any provision of the Securities Act or the Exchange Act or any rule or regulation promulgated thereunder, and (2) that denial is in the "public interest."¹

¹ The portion of Section 15(b) here applicable is as follows:

* * * * *

"The Commission shall, after appropriate notice and opportunity for hearing, by order deny registration to or revoke the registration of any broker or dealer if it finds that such denial or revocation is in the public interest and that (1) such broker or dealer whether prior or subsequent to becoming such, or (2) any partner, officer, director, or branch manager of such broker or dealer (or any person occupying a similar status or performing similar functions), or any person directly or indirectly controlling or controlled by such broker or dealer, whether prior or subsequent to becoming such, (A) has willfully made or caused to be made in any application for registration pursuant to this subsection or in any document supplemental thereto or in any proceeding before the Commission with respect to registration pursuant to this subsection any statement which was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact; or (B) has been convicted

Section 17(a) of the Exchange Act, 15 U.S.C. § 78q(a), requires that every registered broker-dealer keep and preserve such papers and records as the Commission by rules may prescribe.²

The Commission has prescribed rule 17a-3 (17 C.F.R. 240.17a-3) which specifies the books and records to be kept.³

within ten years preceding the filing of any such application or at any time thereafter of any felony or misdemeanor involving the purchase or sale of any security or arising out of the conduct of the business of a broker or dealer; or (C) is permanently or temporarily enjoined by order, judgment, or decree of any court of competent jurisdiction from engaging in or continuing any conduct or practice in connection with the purchase or sale of any security; or (D) has willfully violated any provision of the Securities Act of 1933, as amended, or of this title, or of any rule or regulation thereunder. * * *"

² Section 17(a) provides:

"Every national securities exchange, every member thereof, every broker or dealer who transacts a business in securities through the medium of any such member, *every registered securities association*, and every broker or dealer registered pursuant to section 15 of this title, shall make, keep, and preserve for such periods, such accounts, correspondence, memoranda, papers, books, and other records, and make such reports, as the Commission by its rules and regulations may prescribe as necessary or appropriate in the public interest or for the protection of investors. Such accounts, correspondence, memoranda, papers, books, and other records shall be subject at any time or from time to time to such reasonable periodic, special, or other examinations by examiners or other representatives of the Commission as the Commission may deem necessary or appropriate in the public interest or for the protection of investors."

³ Rule 17a-3 provides:

"(a) Every member of a national securities exchange who transacts a business in securities directly with others than members of a national securities exchange, and every broker or dealer who transacts a business in securities through the medium of any such member, and every broker or dealer registered pursuant to section 15 of the Securities Exchange Act of 1934, as amended, shall make and keep current the following books and records relating to this business:

"(1) Blotters (or other records of original entry) containing an itemized daily record of all purchases and sales of securities, all receipts and deliveries of securities (including certificate numbers), all receipts and disbursements of cash and all other debits and credits. Such records shall show the account for which each such transaction was effected, the name and amount of securities, the unit and aggregate purchase or sale price (if any), the trade date, and the name or other designation of the person from whom purchased or received or to whom sold or delivered.

"(2) Ledgers (or other records) reflecting all assets and liabilities, income and expense and capital accounts.

"(3) Ledger accounts (or other records) itemizing separately as to each cash and margin account of every customer and of such member, broker or

The Securities Act requires the disclosure of pertinent business and financial facts concerning the issuer in connection with a public offering of securities so that investors will be provided with a means of reaching an informed judgment

dealer and partners thereof, all purchases, sales, receipts and deliveries of securities and commodities for such account and all other debits and credits to such account.

"(4) Ledgers (or other records) reflecting the following:

"(A) securities in transfer;

"(B) dividends and interest received;

"(C) securities borrowed and securities loaned;

"(D) monies borrowed and monies loaned (together with a record of the collateral therefor and any substitutions in such collateral);

"(E) securities failed to receive and failed to deliver.

"(5) A securities record or ledger reflecting separately for each security as of the clearance dates all 'long' or 'short' positions (including securities in safekeeping) carried by such member, broker, or dealer for his account or for the account of his customers or partners and showing the location of all securities long and the offsetting position to all securities short and in all cases the name or designation of the account in which each position is carried.

"(6) A memorandum of each brokerage order, and of any other instruction, given or received for the purchase or sale of securities, whether executed or unexecuted. Such memorandum shall show the terms and conditions of the order or instructions and of any modification or cancellation thereof, the account for which entered, the time of entry, the price at which executed and, to the extent feasible, the time of execution or cancellation. Orders entered pursuant to the exercise of discretionary power by such member, broker, or dealer, or any employee thereof, shall be so designated. The term 'instruction' shall be deemed to include instructions between partners and employees of a member, broker, or dealer. The term 'time of entry' shall be deemed to mean the time when such member, broker, or dealer transmits the order or instruction for execution or, if it is not so transmitted, the time when it is received.

"(7) A memorandum of each purchase and sale of securities for the account of such member, broker, or dealer showing the price and, to the extent feasible, the time of execution.

"(8) Copies of confirmations of all purchases and sales of securities and copies of notices of all other debits and credits for securities, cash, and other items for the account of customers and partners of such member, broker, or dealer.

"(9) A record in respect of each cash and margin account with such member, broker, or dealer containing the name and address of the beneficial owner of such account, and, in the case of a margin account, the signature of such owner; provided that, in the case of a joint account or an account of a corporation, such records are required only in respect of the person or persons authorized to transact business for such account.

"(10) A record of all puts, calls, spreads, straddles, and other options in which such member, broker, or dealer has any direct or indirect interest

as to the investment merits of the security.⁴ Before an issue of securities may be sold to the public a registration statement must become effective with the Commission.⁵ A prospectus containing prescribed information must be delivered to all investors. The Act provides certain exemptions from registration where "there is no practical need for its application or where the public benefits are too remote." (H.R. No. 85, 73rd Cong., 1st Sess. (1933), p. 5.)

Section 3(a)(11) of the Securities Act, 15 U.S.C. § 77c(a)(11), exempts from the registration requirements of Section 5: "Any security which is part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business

or which such member, broker, or dealer has granted or guaranteed, containing, at least, an identification of the security and the number of units involved.

"(11) A record of the proof of money balances of all ledger accounts in the form of trial balances. Such trial balances shall be prepared currently at least once a month.

"(b) This rule shall not be deemed to require a member of a national securities exchange to make or keep such records of transactions cleared for such member by another member as are customarily made and kept by the clearing member.

"(c) This rule shall not be deemed to require a member of a national securities exchange, or a broker or dealer registered pursuant to section 15 of the Securities Exchange Act of 1934, as amended, to make or keep such records as are required by paragraph (a) reflecting the sale of United States Tax Saving Notes, United States Defense Savings Stamps, or United States Defense Savings Bonds, Series E, F, and G.

"(d) The records specified in paragraph (a) of this rule shall not be required with respect to any cash transaction of \$100.00 or less involving only subscription rights or warrants which by their terms expire within 90 days after the issuance thereof."

"The essential purpose of the statute [Securities Act] is to protect investors by requiring publication of certain information concerning securities * * * offered for sale." *A. C. Frost & Co. v. Coeur d'Alene Mines Corp.*, 312 U.S. 38, 40 (1941).

⁵ Section 5(a)(1), 15 U.S.C. § 77e(a)(1), provides:

"Sec. 5. (a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—

"(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; * * *

Under Section 5(c) of the Act an offer of securities may not be made before a registration statement is filed.

within, or, if a corporation, incorporated by and doing business within such State or Territory."

2. Statement of facts

P. J. Gruber & Co., Inc. ("registrant"), a New York corporation, is a registered broker and dealer wholly owned and controlled by petitioner, P. J. Gruber ("Gruber"), and through which Gruber has been conducting his securities business since 1954 (R. 118).

On August 29, 1956, after opening a branch office of the registrant at Hempstead, Long Island, Gruber opened a Washington branch office (R. 118). Shortly thereafter, Gruber incorporated under the laws of Delaware a second wholly-owned corporation named P. J. Gruber & Co., Inc. ("applicant"), and on September 25, 1956, he caused to be filed with the Commission in the name of this Delaware corporation an application for registration as a broker and dealer naming Phil Sacks, who was office manager of registrant's Washington office, as president of the applicant (R. 119).

The Commission by order dated October 22, 1956, upon a finding that it was necessary and appropriate in the public interest, deferred the effective date of registration of the applicant until November 3, 1956. On November 2, 1956, while the application was still pending, the Commission ordered a hearing to determine whether it was in the public interest to deny the application. At the conclusion of the public hearing, Gruber requested withdrawal of the application (R. 111).

After the submission of briefs, proposed findings and oral argument, the Commission, by order dated January 15, 1958, denied the application for registration and also the request for withdrawal (R. 201). In its accompanying Findings and Opinion (R. 195) the Commission found that Gruber through registrant had willfully violated Section 5(a)(1) of the Securities Act in that, by use of the mails and interstate facilities, registrant sold 49,500 shares of the common stock of Acoustica Associates, Inc. when no registration statement was in effect as to such stock. The Commission further found that Gruber through registrant willfully violated Section 17(a) of the Exchange Act and Rule 17a-3 thereunder in that book entries

were made showing sales of stock where the persons solicited had not agreed to purchase the stock. In view of these violations and under all the circumstances the Commission concluded that it was in the public interest to deny the application for registration.

Gruber has admitted (R. 113) on behalf of himself and the registrant that between March 5, 1956 and March 22, 1956, registrant sold in accordance with Gruber's directions shares of the common stock of Acoustica Associates, Inc. and that these sales were in violation of Section 5(a) of the Securities Act of 1933. It was stipulated (R. 119) that if Gruber were called as a witness he would testify that during the period in which these sales of unregistered shares of Acoustica stock occurred he was out of the country, that he had given his office manager instructions to sell these shares only to New York residents (R. 120), that four sales were made to persons not resident of New York, and that he realized that he was responsible for the actions of his employees.

Beginning on August 15, 1956, a high rate of cancellations of purported sales began appearing on the books and records of the registrant. It is agreed (R. 113-115) that in the period between August 15, 1956 to November 2, 1956, the cancellations amounted to 40 percent of the purported sales of stock of Century Controls Corp. ("Century"); between November 16, 1956, and December 28, 1956, cancellations increased to 52 percent. It is further agreed that from September 12, 1956 to October 25, 1956, there were cancellations of 42 percent of the purported sales from registrant's account carried as underwriter for Perfect-Line Manufacturing Corporation ("Perfect-Line"); from October 16 to October 31, 1956, there were cancellations aggregating 15 percent of the purported sales by registrant of Perfect-Line stock from its own trading account.

Although Gruber admitted being aware of this high rate of cancellations in the period from August 15, 1956 to November 2, 1956 (R. 121), he offered no evidence that he took any steps to correct this situation or even to discover the cause of these cancellations before he left the country on November 2, 1956. He attributed this high rate of cancellations to the numerous inexperienced personnel in his employ and to the lack of supervision by office managers (R. 121). However

Sacks, manager of the Washington office, testified that from the beginning Gruber was aware that registrant was advertising for and hiring inexperienced salesmen in the Washington office (R. 45, 46).

Sacks testified that all sales were reported daily to the New York office (R. 47) where Gruber conducted his business and where the books and records were kept (R. 30). A daily list of sales, including the names of the salesmen who had solicited them, was prepared and mailed to New York. There also were telephone conversations between Sacks and Gruber in relation thereto (R. 47-48).

It was stipulated that if Mr. Albert Friedman, the bookkeeper in the Washington office, were called as a witness he would testify that upon being advised of the commencement of the Commission's denial proceedings he instituted in the first or second week of November a procedure whereby he personally contacted by telephone each customer who had placed a purchase order for the purpose of verifying the order. However, Friedman was discharged by Sacks, and was not in the Washington office from November 9, 1956 to November 20, 1956. On the latter date he replaced Sacks.

Sacks, who remained as manager of the Washington office until November 20, 1956, testified that when verification procedures were instituted in the Washington office the cancellations ceased. When Gruber instituted such procedures in the New York office upon his return to the United States on December 10, 1956, a similar trend occurred (R. 123).

It is admitted that Margaret Howell, Vernon Barrack, Frank Wright, Samuel Lasky and *others* were contacted and solicited by salesmen of registrant working out of its Washington branch office, and that if these and *other* witnesses were called they would testify as follows:

* * * during the period from October 20, 1956, they were each called on the telephone on several occasions by representatives of *P. J. Gruber & Co., Inc.*, Washington, D. C. office, who *made vigorous attempts to induce each of them to purchase shares* of the common stock of Century Controls Corporation's stock; that it was

suggested to each of said persons that P. J. Gruber & Co., Inc. be allowed to send out a confirmation to protect the stock for them and that *none of the said persons so solicited ever agreed to purchase the stock, but notwithstanding this each of said persons so solicited did receive, through the United States mails, a confirmation of sales to them of shares of common stock of Century Controls Corporation which they, in fact, never agreed to purchase.* (Emphasis added.) (R. 115, 116.)

The petitioners also stipulated that:

Registrant, Peter J. Gruber and Phil Sacks admit that a temporary restraining order was entered on November 15, 1956, in the U.S. District Court for the Southern District of New York, and that subsequently a Preliminary Injunction was entered on January 7, 1957, in said Court, by consent of the registrant and Peter J. Gruber and by default in the case of Phil Sacks, enjoining each of them from making false and fictitious entries in the books and records relating to the registrant's business, which books and records are required to be made and kept current by Section 17(a) of the Securities Exchange Act of 1934 and Rule X-17A-3 thereunder (now referred to as Section 240.17a-3 of the General Rules and Regulations).⁶ (R. 133-134.)

SUMMARY OF ARGUMENT

I

It is conceded that the sales of Acoustica stock were made in violation of Section 5(a) of the Securities Act which prohibits *any* sale of unregistered securities. While Gruber had hoped to avail himself of an exemption from this provision, he did not meet the terms of the exemption. In these circumstances, since Gruber specifically instructed his salesmen to sell the stock and knew that the stock was not registered with the Commission, Gruber, acting through the registrant, his corporate alter ego, willfully violated the statute.

⁶ It should be noted that the petitioners make no reference in the stipulation to any condition restricting the use of the injunction.

II

Gruber willfully violated Section 17(a) of the Exchange Act and Rule 17a-3 thereunder, important instruments in the statutory pattern of regulation and necessary to effectuate the Congressional policy of providing investor safeguards.

In the case of both the Century and the Perfect-Line stocks there was an extremely high rate of cancellation of purported sales to customers who received confirmations. Confirmations, in accordance with the universally accepted practice in the securities industry, reflect a completed transaction, and there is no warrant for the suggestion now made by petitioners that the confirmations here were merely an option to purchase.

The record shows clearly that the registrant recorded as completed transactions purported sales to customers who had not agreed to purchase Century stock, and this was not limited to four customers as petitioners argue. These entries were clearly false and fictitious as found by the Commission. Furthermore in the face of the record, the Commission also was wholly warranted in reaching the same conclusion with respect to the entries made on registrant's books for the purported sales in the Perfect-Line stock.

Gruber had the duty to supervise adequately his branch office and he cannot shift this responsibility to employees of that office.

The record shows that Gruber was fully aware of the operations of the Washington branch office and of the high rate of cancellations which began August 15, 1956, but took no effective corrective action before December 10, 1956, which was 38 days after the Commission instituted these proceedings. He was aware also, from the time that the Washington branch office was opened, of the practice to advertise for and hire only inexperienced salesmen, the practice to which he attributes the improper conduct involved.

III

In view of these circumstances, including the continuing lack of supervision by Gruber of his salesmen, the consistent record of false and fictitious entries in registrant's books and records, and the sale of unregistered securities in violation of

the Securities Act, it was not an abuse of discretion for the Commission to refuse Gruber's application to extend his operations by means of another corporate alter ego.

ARGUMENT

I. The Commission correctly concluded that Gruber willfully violated Section 5(a) of the Securities Act

The Commission in its Findings and Opinion found that:

Registrant and Gruber, admit * * * that between March 5 and March 22, 1956, registrant used the mails and interstate facilities in the sale of 49,500 shares of Acoustica stock when no registration statement was in effect as to such stock, in violation of Section 5(a) of the Securities Act. Under the circumstances, we conclude that Gruber through registrant willfully violated Section 5(a)(1) of that Act (R. 197).

The registrant, P. J. Gruber & Co., Inc., is wholly owned and controlled by Gruber. He is President, Treasurer, and a Director, and owns directly or indirectly 100% of the voting stock of the registrant. In the stipulation of facts Gruber describes the registrant's operation as one in which "he has operated his own securities business from October 1954 to date" (R. 118). Consequently the registrant is no more than an alter ego through which Gruber conducts his securities business.

Absent an exemption—and none is claimed here—the sale of unregistered securities to the public is unlawful under Section 5(a) of the Securities Act. Indeed the violation is admitted. However, it is claimed that the violation was not willful on the part of Gruber.

The facts show that Gruber knew that the Acoustica securities had not been registered. He directed the sale of these securities to the public by the use of the mails with the full knowledge that the public investor would not receive the information about the security that a registration statement and a prospectus would afford him as required by Section 5. These sales were willful and intentional.

Gruber does not deny that all these sales then were intentional and willful and made under his instructions. He con-

tends that he sought to come within the exemption provided by Section 3(a)(11), but at the same time he admits that he did not bring himself within the terms of this exemption.⁷ While he was abroad, these shares were sold pursuant to his directions. If all his instructions had been obeyed, Gruber would, at least in this regard, have been in a position to claim the availability of the exemption he originally anticipated. The fact is that his instructions were not obeyed. The nonfulfillment of his desires, no matter what they might have been, does not detract from the fact that he knowingly and willfully directed the sales of unregistered stock. And these sales were made in violation of Section 5.⁸

The Securities Act is a remedial statute, and "the terms of * * * an exception * * * must be 'strictly construed' against the claimant of its benefit," *S.E.C. v. Sunbeam Gold Mines Co.*, 95 F. 2d 699, 701 (C.A. 9, 1938). The claimant of an exemption relies thereon at his peril. As the Supreme Court pointed out:

Keeping in mind the broadly remedial purposes of federal securities legislation, imposition of the burden of proof on an issuer who would plead the exemption seems to us fair and reasonable. *S.E.C. v. Ralston Purina Co.*, 346 U.S. 119, 126 (1953).

Transactions by a registrant, a corporate entity, which violate the Act, necessarily stem from actions by individuals which

⁷ Section 3(a)(11), 15 U.S.C. § 77c(a)(11), reads as follows:

"3(a) Except as hereinafter expressly provided, the provisions of this subchapter shall not apply to any of the following classes of securities: * * * (11) Any security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within, or, if a corporation, incorporated by, and doing business within, such state or Territory."

⁸ Although Petitioners in their brief make much of the fact that Gruber's salesmen may have sold these shares to investors outside of the State of New York through inadvertence, there is no evidence in the record that these sales were consummated through inadvertence. In fact Petitioners in their brief for the first time question Gruber's stipulated admission in this regard. Section 25(a) of the Exchange Act provides, *inter alia*: "No objection to the order of the Commission shall be considered by the court unless such objection shall have been urged before the Commission." There is nothing in the record to indicate that Gruber's salesmen did not know they were making interstate sales.

themselves violate the Act. Protection of the public investor would be completely frustrated if a registrant could absolve itself of responsibility for preventing violations of the Securities Act merely by a general instruction to its employees that they should not violate the law.

In determining the question of the responsibility of the registrant and Gruber for the violations in this case, it should be borne in mind that the provisions for administrative regulation of the over-the-counter markets contained in Section 15 of the Exchange Act places responsibility for violations directly on registrants engaged in the securities business, and only indirectly on their employees. Section 15(b) provides for registration and revocation of registration only of brokers and dealers. Registration of a partnership in effect covers all the partners who constitute the firm. Salesmen are not even named in an application for a broker-dealer registration, and are neither registered themselves nor subject to direct administrative sanction. *Wallach v. S.E.C.*, 93 App. D.C. 41, 202 F. 2d 462, 463 (C.A.D.C. 1953). Thus the statute clearly contemplates that registrants engaged in the securities business must shoulder the responsibility for the conduct of their salesmen.⁹

In determining the existence of a willful violation under the Act, the Commission has long held that a willful violation occurs if the person charged with the violation intended to do the acts from which the violation results.¹⁰ Gruber here intended to sell the unregistered stock. It is the sale of such stock which resulted in a violation of Section 5 of the Act.¹¹ Gruber need not have a bad purpose in mind or suppose that he is breaking

⁹ In *R. H. Johnson & Co. v. S.E.C.*, 198 F. 2d 690, 696-697 (C.A. 2, 1952) cert. den. 344 U.S. 855, the Court rejected the argument that Johnson was not a "cause" of the firm's expulsion within the meaning of Section 15A(b)(4) of the Exchange Act because he was not personally guilty of the violations charged. The same argument was subsequently made before this Court in a later proceeding involving the same petitioner Johnson, and was rejected in a *per curiam* affirmance. *R. H. Johnson & Co. v. S.E.C.*, 97 App. D.C. 364, 231 F. 2d 523 (C.A.D.C. 1956) cert. denied, 352 U.S. 844.

¹⁰ *Robert Dermot French*, 36 S.E.C. 603 (1955), and cases therein cited.

¹¹ Since Section 5 by its terms outlaws *any* sale of unregistered shares, it is not necessary to show that Gruber intended to make the sales to out-of-state residents in order for his violations to be willful.

the law. As this Court stated in *Hughes v. S.E.C.*, 85 App. D.C. 56, 64, 174 F. 2d 969, 977 (1949), in considering the meaning of "willful" under Section 15(b) of the Exchange Act:

It is only in very few criminal cases that "willful" means "done with a bad purpose." Generally, it means "no more than that the person charged with the duty knows what he is doing. It does not mean that, in addition, he must suppose that he is breaking the law."¹²

This Court, only a few weeks ago, again reaffirmed this interpretation of Section 15(b). *Shuck v. S.E.C.*, —App. D.C. —, —F. 2d — (C.A.D.C., 1958).

Petitioners rely heavily in this regard on *Broadcasting Service Organization v. Federal Communications Commission*, 84 App. D.C. 152, 171 F. 2d 1007 (1948), which they urge requires a different meaning for "willfulness" than that stated above. It appears, however, that they overlooked the fact that the decision was reversed at 337 U.S. 901 (1949).

We submit that the record supports the finding that registrant and Gruber willfully violated the Securities Act of 1933.

II. The Commission correctly concluded that Gruber willfully violated Section 17(a) of the Securities Exchange Act and Rule 17a-3 thereunder

A. The entries in registrant's books were false and fictitious

The Commission found that during the period from August 15 to December 10, 1956, registrant engaged in a practice of mailing confirmations of sales of stock which were entered in its books and records as actual sales although the ostensible purchasers had never agreed to purchase the stocks. When the purchasers refused to make payment for these securities which they had not ordered, entries were made showing cancellations of the sales previously recorded.

On August 29, 1956, Gruber opened a Washington branch office of the registrant with Phil Sacks as office manager.

¹² As Justice Holmes expressed it:

"If a man intentionally adopts certain conduct in certain circumstances known to him, and that conduct is forbidden by the law under those circumstances, he intentionally breaks the law in the only sense in which the law ever considers intent." *Ellis v. United States*, 206 U.S. 246, 257 (1907).

From the time the Washington office was opened, the customer business conducted by that office was solely through telephone solicitations. The offices were equipped with ten separate outside phones, a trunk line with twelve extensions, and eight more separate phone installations in the training room (R. 122).

An examination of registrant's books and records, which were maintained in New York where Gruber operated, disclosed that in the period between August 15, 1956, and November 2, 1956, out of 502 purported sales of Century stock recorded on the books, 191 sales or 40 percent were cancelled. In addition, in the period from September 12, 1956, to October 25, 1956, 42 percent of the purported sales of Perfect-Line stock recorded by registrant as underwriter were cancelled (343 cancellations out of 739 sales) (R. 113-115).

Petitioners stipulated that, if the Commission's witnesses were called—Margaret Howell, Vernon Barrachs, Frank Wright, and Samuel Laskey and *others*—they would testify that “during the period from October 1, 1956 to October 20, 1956, they were each called on the telephone on several occasions by representatives of P. J. Gruber & Co., Inc., Washington, D. C. office, who made vigorous attempts to induce each of them to purchase shares of common stock of Century Controls Corporation's stock; that it was suggested to each of said persons that P. J. Gruber & Co., Inc. be allowed to send out a confirmation to protect the stock for them and that none of the said persons so solicited ever agreed to purchase the stock, but notwithstanding this, each of the said persons so solicited did receive, through the United States mails, a confirmation of sales to them of shares of common stock of Century Controls Corporation which they, in fact, never agreed to purchase” (R. 115-116).

It should be noted at this point that petitioners' argument with respect to this violation is premised on a distortion of the stipulation. Throughout their brief they emphasize that there were “only 4 individuals” who received confirmations of sale who had not agreed to purchase the stock (e.g. Br. p. 27). That is not so. There were only four individuals mentioned by name, but the stipulation (R. 115) specifically

states that these four individuals *and others* would so testify. These *others* could include any of the 191 individuals who returned or ignored the confirmations and were not deceived by this device into believing that they were liable for the purchase price of the stock.

It is the universal practice in the securities business to send a written confirmation to the customer only when the broker-dealer has filled the customer's order. This confirms the customer's order, and, in the case of a purchase, notifies him that the security has been credited to his account. In other words, it is a confirmation of a completed transaction—a completed sale or purchase—and is binding on the customer. It is apparent from the record that Gruber's salesmen were sending out confirmations to persons whom they had solicited, but who had not agreed to purchase, in the hope that the customer would think he was bound to purchase the stock; thereby increasing the number of sales, and, hence, the salesmen's commissions and the firm's profits.

Petitioners now for the first time advance a novel theory. They argue that the confirmations, contrary to the universal practice, were nothing more than options to buy until exercised by the purchaser.¹³ Based on this fallacious premise, petitioners argue that the Commission could not reasonably find that these entries were false and fictitious even though consummated sales were recorded when the customer had not agreed to purchase.

This argument, we believe, only tends to emphasize the falsity of the book entries. A confirmation is exactly what the name implies. It confirms (and states on its face that it confirms) a final and completed sale. The concession, that the books showed as completed sales, transactions, which were only offers to sell, admits the matter at issue, namely, that the books and records of registrant contain false and fictitious entries.

As already pointed out, the stipulation clearly shows that registrant's books and records falsely reflected as sales, situations where the customers had not agreed to purchase the

¹³ In making this argument, petitioners tacitly accept the Commission's rejection of the testimony of registrant's salesmen that confirmations were sent out only after the customer had agreed to purchase the securities (R. 28, 35, 36, 77, 78).

stock. Unable to controvert these admitted facts, petitioners seek to rebut the inexorable conclusion which the Commission reached by arguing that after verification procedures were instituted in the Washington office in the second week of November the rate of cancellations increased. Even accepting this, it in no way renders truthful the fictitious entries made. But, in any event, the short answer to the entire line of argument is that cancellations continued at a very high rate until December 10, 1956, when Gruber intervened to correct these practices. It was not until this late date (38 days after the institution of these proceedings) that cancellations were discontinued in all offices. This fact demonstrates clearly: (1) that other so-called verification procedures were grossly ineffective, and (2) effective procedures could be instituted.

Petitioners state (Br. p. 37) that they cannot conceive of how the entry of sales on registrant's books, although no sales had actually been made, could possibly be injurious to the Commission's functions or to investors. Apart from the fact that this practice may deceive innocent and uninformed public investors, these false and fictitious entries in a broker-dealer's books are per se a violation of the statutes and Commission regulations. If these requirements are to have any meaning at all, entries must be truthful and reflect honestly the transactions recorded.

The importance Congress attached in the statutory pattern of regulation to the maintenance of accurate books and records by brokers-dealers is amply demonstrated by the fact that this was covered in a specific provision, which was given breadth by authorizing the Commission, by rule, to require books and records "as necessary or appropriate in the public interest or for the protection of investors." A consistent record of violation of the Commission's rules, which are designed to assure the integrity of a broker-dealer's books, a matter the Congress considered important, is not to be dismissed cavalierly.

Additionally, these false entries could be significant in a number of ways but one example should suffice. In Section 15(c) (3) of the Exchange Act, 15 U.S.C. 78o(3)(c), Congress empowered the Commission by rule to provide safeguards to ensure the financial responsibility of broker-dealers and also prohibited broker-dealers from engaging in transactions as

broker-dealers while violating the rules prescribed for that purpose.

Pursuant thereto the Commission promulgated Rule X-15c3-1, 17 CFR 240.15c3-1.¹⁴ This Rule prohibits a broker or dealer from permitting his aggregate indebtedness to exceed 2000 per centum of his net capital. Inspections are made by Commission personnel to determine whether or not these requirements are being met by registrants.

In order to furnish a cushion for fluctuations in the market value of securities held in a broker-dealer's portfolio, the rule provides that in computing net capital there must be deducted 30% of the value of all unsold securities held by the broker-dealer (with certain exceptions not here applicable).¹⁵ It is evident, therefore, that a broker-dealer's net capital position as shown by his books and records would be substantially different depending on whether the transactions of the type here involved were carried as accounts receivable or reflected

¹⁴ This Court recently considered this Rule in connection with the revocation of the registration of another broker-dealer for violations of the rule. *Shuck v. S.E.C.*, — App. D.C. —, — F. 2d — (C.A.D.C. December 4, 1958).

¹⁵ Paragraph (c) (2) (C) of the Rule reads, in part:

"(c) Definitions—For the purpose of this rule—

* * * * *

"(2) The term "net capital" shall be deemed to mean the net worth of a broker or dealer (that is, the excess of total assets over total liabilities), adjusted by * * *

"(C) deducting the percentages specified below of the market value of all securities, long and short (except exempted securities) in the capital, proprietary and other accounts of the broker or dealer, including securities loaned to the broker or dealer pursuant to a satisfactory subordination agreement, as hereinafter defined, and if such broker or dealer is a partnership, in the accounts of partners, as hereinafter defined:

(i) in the case of non-convertible debt securities having a fixed interest rate and a fixed maturity date which are not in default, if the market value is not more than 5% below the face value, the deduction shall be 5% of such market value; if the market value is more than 5% but not more than 30% below the face value, the deduction shall be a percentage of market value, equal to the percentage by which the market value is below the face value; and if the market value is 30% or more below the face value, such deduction shall be 30%;

"(ii) in the case of cumulative, non-convertible preferred stock ranking prior to all other classes of stock of the same issuer, which is not in arrears as to dividends, the deduction shall be 20%;

"(iii) on all other securities, the deduction shall be 30% ;"

as unsold stock in his inventory. The very great number of false entries here involved could well make the difference between compliance with the Rule on the one hand and violation thereof on the other.

Petitioners assert that there is no support in the record for the finding that the entries with respect to the Perfect-Line stock were false. However, the books and records of the registrant disclose that 343 out of 739, or 42 percent, of the purported sales of Perfect-Line stock in the period from September 12, 1956 to October 25, 1956, from the underwriting account were later cancelled. In addition 15 percent of registrant's purported sales of Perfect-Line from October 16, 1956 to November 30, 1956, from its own trading account were also cancelled. When these figures are examined in light of the whole record [*Universal Camera Corp. v. National Labor Relations Board*, 340 U.S. 474 (1951)], including the tremendously high rate of cancellations of the sales of Century Controls stock and the corresponding stipulated testimony of investor-witnesses showing that the entries with respect to their stock were false, the Commission was justified in drawing the inference that the entries made in registrant's books with respect to the Perfect-Line stock were the result of the same pattern.

It is hard to see how the process of fact finding can go on unless the trier may make the deductions which *experience* teaches are reasonable and justified (emphasis added). *United States v. Thompson*, — F. 2d — (C.A. 2, December 2, 1958).¹⁶ (Emphasis supplied.)

B. Petitioner Gruber is responsible for the conduct of his salesmen and willfully violated Section 17(a) of the 1934 Act

Petitioners seek to create the impression that the Washington branch office was completely autonomous under the direction of Sacks. On the contrary, the record shows that Gruber was fully informed of that office's daily operations and exercised

¹⁶ See also *United States v. Masiello*, 235 F. 2d 279, 284, 285 (C.A. 2, 1956), cert. denied sub nom. *Stickel v. United States*, 352 U.S. 882 (1956). In *F.T.C. v. Pacific States Paper Ass'n.*, 273 U.S. 52, 63 (1927), the Supreme Court stated: "The weight to be given to the facts and circumstances admitted, as well as the inferences reasonably to be drawn from them, is for the Commission."

overall supervision, although obviously inadequate, of its activities. The transactions of the Washington office were reported daily (R. 47) to Gruber's New York office as were the names of the salesmen who had solicited the customers. Registrant's books were kept in the New York office and were available to Gruber at all times (R. 30). Indeed, Gruber admits being aware of the high rate of cancellations during the period from August 15 to November 2, 1956 (R. 121).

In the stipulation Gruber states that he attributes these cancellations to his many inexperienced salesmen (R. 121). But the Washington office from the time it was opened in late August, 1956, was advertising for and hiring only inexperienced salesmen as Gruber knew (R. 45, 46).¹⁷ It was not until October or November 1956 that he ordered all such advertising to be discontinued (R. 45-46, 122). This is the only evidence in the record which suggests even the slightest responsible supervision by Gruber over his salesmen.

Other than this belated discontinuance of advertising and hiring policies, there is not a shred of evidence to indicate that Gruber, although aware of the phenomenally high rate of cancellations from August 15 to November 2, 1956, and of the fact that the Commission was conducting an investigation in October 1956, took any effective corrective action before December 10, 1956.

As previously pointed out, Section 15(b) contemplates that the registrant or persons controlling it must bear the responsibility for the conduct of their salesmen. However, Gruber has sought to shift the responsibility to his subordinates for his failure adequately to supervise his salesmen. To permit this without imposing sanctions would foster a complete disregard of the Commission's rules and regulations by the very persons whom Congress sought to regulate. In *R. H. Johnson and Company v. S.E.C.*, 198 F. 2d 690, 696-697 (C.A. 2, 1952), *cert. denied* 344 U.S. 855, the court stated:

Johnson's interpretation would encourage ethical irresponsibility by those who should be primarily respon-

¹⁷ Sacks testified that Gruber knew of this advertising and hiring policy from its inception (R. 45-46). Gruber claimed, but the Commission did not believe, that he did not learn of these matters until October 1956.

sible for such adherence. If Johnson's contentions were sound, then, in order to circumvent those principles, a person controlling a firm would merely have to arrange to leave wholly unsupervised its employees who deal with customers. We think Johnson's irresponsible behavior with respect to supervision amounted to such recklessness as to justify the finding that he was a "cause" of the firm's expulsion.

See also *R. H. Johnson and Company v. S.E.C.*, 97 App. D.C. 364, 231 F. 2d 523 (C.A.D.C., 1956) cert. denied 352 U.S. 844.

III. The Commission did not abuse its discretion in concluding that it was in the public interest to deny the applicant's registration

As set out previously, the Commission found that Gruber through registrant, his alter ego, had willfully violated the registration requirements of the Securities Act and the record-keeping requirements of the Exchange Act. Upon the basis of these violations, and the circumstances under which they were made, the Commission found that:

* * * it [is] necessary and appropriate in the public interest that applicant's application for registration as a broker and dealer be denied, and to deny applicant's request for withdrawal of its application for registration. We further conclude that Gruber and Sacks are each a cause of the order entered herein denying the application (R. 200).

In support of this finding the Commission's opinion recites in detail the circumstances which warranted this finding of denial. Outstanding among these was Gruber's continuing lack of supervision of his salesmen. As the record and the Commission's opinion indicate, this is especially true in relation to the practice of recording sales on the books when sales had not actually been made. Gruber was aware of the high rate of cancellations more than two months before the Commission's order noticing the administrative hearing, and was aware of the practice of hiring inexperienced persons as salesmen from the beginning. His response was inaction—an obvious disregard of his duties.

In view of Gruber's irresponsibility the Commission's finding that it was not in the public interest to permit Gruber to expand his activities through a new registered corporate alter ego was proper.

In addition to these detailed findings, the Commission noted that Gruber, as well as the registrant and Sacks, admitted in the record (R. 133) and at the oral argument before the Commission (R. 228) that a preliminary injunction based upon charges of violations of the record-keeping rules involving the same bookkeeping entries at issue in this case, was entered on January 7, 1957, by the United States District Court for the Southern District of New York. This injunction was entered with the consent of registrant and Gruber, and on default by Sacks, and enjoined each of them from making false and misleading entries in registrant's books and records pending a decision on the merits of those charges.

We do not understand the impact of petitioner's argument concerning the condition entered by Judge Palmieri or its relevance to this proceeding. It is to be observed that no mention is made of this condition in the record and the Commission was not in fact aware of it, whatever its "official memory" is supposed to be. In any event, that proviso related only to *revocation* proceedings against the existing registration. There is no reference to *denial* proceedings involving a new registrant. It certainly could not have been the Judge's intention to tie the hands of the Commission and compel it to accept without question any *new* applications Gruber sought to file. The condition apparently was deemed so lacking in significance by petitioners that they did not put it into the stipulation or even refer to it in their brief or oral argument before the Commission. Moreover, the denial was not based on the injunction which was mentioned only incidentally in the Commission's opinion.¹⁸

The courts have repeatedly emphasized the "fundamental principle * * * that where Congress has entrusted an administrative agency with the responsibility of selecting the means

¹⁸ Under Section 15(b) the Commission could, if appropriate in the public interest, deny registration merely on the basis of an injunction. See *Shuck v. S.E.C.*,—App. D.C.—, —F. 2d —, (December 4, 1958). But the Commission here did not rely on the injunction as the statutory basis for its action.

of achieving the statutory policy 'the relation of remedy to policy is peculiarly a matter for administrative competence.' " *American Power and Light Co. v. S.E.C.* 329 U.S. 90, 112 (1946), citing, *Phelps Dodge Corp. v. Labor Board*, 313 U.S. 177, 194 (1941). And see *Moog Industries, Inc. v. FTC*, 355 U.S. 411, 413 (1958). In the *American Power and Light Co.* case, the Court also noted (329 U.S. at 112-113):

While recognizing that the Commission's discretion must square with its responsibility, only if the remedy chosen is unwarranted in law or is without justification in fact should a court attempt to intervene in the matter.

The Commission did not abuse its discretion in denying the application for registration.

CONCLUSION

The order of the Commission should be affirmed.
Respectfully submitted.

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FEBRUARY 1959.